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UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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**Form 10-K**

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

For the fiscal year ended December 31, 2008

or

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

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

Commission File Number: 001-33852

**VirnetX Holding Corporation**

*(Exact name of Registrant as specified in its charter)*

**Delaware**

*(State or other jurisdiction of incorporation or organization)*

**77-0390628**

*(I.R.S. Employer Identification Number)*

**5615 Scotts Valley Drive, Suite 110  
Scotts Valley, California**

*(Address of principal executive offices)*

**95066**

*(Zip Code)*

**(831) 438-8200**

**(Registrant's telephone number, including area code)**

**Securities registered pursuant to Section 12(b) of the Act:**

<u>Title of Class</u>	<u>Name of Exchange on Which Registered</u>
Common Stock, par value \$0.0001 per share	NYSE Amex

**Securities registered pursuant to Section 12(g) of the Act:**

**None**

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes  No

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.  
Yes  No

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405) is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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 aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant as of June 30, 2008, was \$123,163,825 based upon the closing price of the common shares of the Registrant on June 30, 2008. This calculation does not reflect a determination that certain persons are affiliated of the Registrant for any other purpose.

37,369,985 shares of Registrant's Common Stock were outstanding as of March 26, 2009.

**DOCUMENTS INCORPORATED BY REFERENCE**

Certain portions of this Annual Report on Form 10-K incorporate by reference information from the Registrant's Proxy Statement to be filed with the Securities and Exchange Commission in connection with the solicitation of proxies for the Registrant's 2009 Annual Meeting of Stockholders.

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**Statement regarding forward-looking statements**

*This Annual Report on Form 10-K includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. All statements other than statements of historical facts contained in this Annual Report on Form 10-K, including statements regarding our current liquidity, future financial position, business strategy and plans and objectives of management for future operations, are forward-looking statements. The words “believe,” “may,” “will,” “estimate,” “continue,” “anticipate,” “intend,” “expect” and similar expressions, as they relate to us, are intended to identify forward-looking statements. We have based these forward-looking statements largely on our current expectations and projections about future events and financial trends that we believe may affect our financial condition, results of operations, business strategy and financial needs. These forward-looking statements are subject to a number of risks, uncertainties and assumptions described in “Risk Factors” and elsewhere in this Annual Report on Form 10-K. These risks are not exhaustive. Other sections of this Annual Report on Form 10-K include additional factors which could adversely impact our business and financial performance. Moreover, we operate in a very competitive and rapidly changing environment. New risk factors emerge from time to time and it is not possible for our management to predict all risk factors, nor can we assess the impact of all factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements. You should not rely upon forward-looking statements as predictions of future events. We cannot assure you that the events and circumstances reflected in the forward-looking statements will be achieved or occur and actual results could differ materially from those projected in the forward-looking statements.*

**PART I**

**Item 1. Business.**

**The Company**

We are developing and commercializing software and technology solutions for securing real-time communications over the Internet. Our patented GABRIEL Connection Technology™ combines industry standard encryption protocols with our patented techniques for automated domain name system, or DNS, lookup mechanisms, enabling users to create a secure communication link using secure domain names. We also intend to establish the exclusive secure domain name registry in the United States and other key markets around the world. Our software and technology solutions provide the security platform required by next-generation Internet-based applications such as instant messaging, or IM, voice over Internet protocol, or VoIP, mobile services, streaming video, file transfer and remote desktop. Our technology generates secure connections on a “zero-click” or “single-click” basis, significantly simplifying the deployment of secure real-time communication solutions by eliminating the need for end users to enter any encryption information.

We intend to license our patents and our GABRIEL Connection Technology™ to original equipment manufacturers, or OEMs, within the IP-telephony, mobility, fixed-mobile convergence and unified communications markets. The leaders in these markets include Alcatel-Lucent, Avaya Inc., Cisco Systems, Inc., Juniper Networks, Inc., LM Ericsson Telephone Company, Motorola, Inc., NEC Corporation, Nokia Corporation, Nortel Networks Corporation, Samsung Electronics Co. Ltd. and Sony Ericsson Mobile Communications AB, among others. We also intend to license our patent portfolio, technology and software, including our secure domain name registry service, to communication service providers as well as to system integrators. We believe that the market opportunity for our software and technology solutions is large and expanding. As part of our licensing strategy, in March 2008, we hired ipCapital Group, a leading advisor on licensing technology and intellectual property, to initiate discussions with several major potential licensees. Since its founding in 1998, ipCapital Group has supported the licensing efforts of clients across a variety of technologies and markets, resulting in transactions representing several hundred million dollars of value. We are currently in discussions with prospective customers in our target markets.

Our portfolio of intellectual property is the foundation of our business model. We currently have 12 patents in the United States and eight international patents, as well as several pending U.S. and foreign patent applications. Our patent portfolio is primarily focused on securing real-time communications over the Internet, as well as related services such as the establishment and maintenance of a secure domain name registry. Our software and technology solutions also have additional applications in operating systems and network security. The core development team behind our patent portfolio, technology and software has worked together for over ten years and is the same team that invented and developed this technology while working at Science Application International Corporation, or SAIC. SAIC is a FORTUNE 500® scientific, engineering, and technology applications company that uses its deep domain knowledge to solve problems of vital importance to the nation and the world, in national security, energy and the environment, critical infrastructure and health. We acquired this patent portfolio in 2006, and it now serves as the foundation of our planned licensing and service offerings. We expect to derive the majority of our revenue from license fees and royalties associated with these patents. We also intend to continue our research and development efforts to further strengthen and expand our patent portfolio, and over time, we plan to leverage this portfolio to develop a product suite that can be sold to enterprise customers and developers.

## **Industry Overview**

The Internet is increasingly evolving into a rich medium used by individuals and businesses to conduct commerce, share information and engage in real-time communications including email, text messaging, IM, and voice and video calls. This communications experience is richer and more complex than ever before. Session initiation protocol, or SIP, was developed to enable the convergence of voice and data networks and today is the predominant industry standard for establishing multimedia communications over the Internet such as voice, video, instant messaging, presence information and file transfer. SIP, as well as other real-time collaboration protocols such as XMPP, use DNS lookup as its primary means of connecting Internet devices but is an open architecture that remains inherently insecure.

We believe that accessing a diversity of services from a single device, anytime and anywhere, and the ability to access these same services from a range of devices, are emerging as key market requirements. The portions of the IP-telephony, mobility, fixed-mobile convergence and unified communications markets that could benefit from our software and technology solutions are forecasted by Infonetics to grow total revenues from approximately \$59 billion in 2006 to approximately \$162 billion by 2011, representing a compound annual growth rate, or CAGR, of approximately 22%. This growing trend represents a significant opportunity for VimetX to license its patent portfolio, technology and software, and establish its secure domain name registry.

### ***IP Telephony***

IP telephony includes technologies that use Internet Protocol's packet-switched connections to exchange voice, fax, and other forms of information traditionally carried over the dedicated circuit-switched connections of the public switched telephone network, or PSTN. The adoption of IP telephony has helped businesses significantly lower network operating costs by using a common network for voice and data. As the workforce becomes increasingly dispersed, mobile features enabled by Internet protocol-based communications such as presence, unified messaging, peer-to-peer applications, find me/follow me, white-boarding and document sharing have become more commonplace. However, the development of the related security infrastructure has lagged behind, leaving next-generation networks vulnerable to a multitude of threats including man-in-middle, eavesdropping, domain hijacking, distributed denial of service, or DDoS, spam over Internet telephony, or SPIT, and spam over instant messaging, or SPIM. These threats continue to highlight the need for securing next-generation networks. As the use of IP telephony systems extends beyond the boundaries of an organization's private network, security is likely to become an even bigger concern. Worldwide revenue from IP telephony products like IP-PBX including IP phones, service provider VoIP and IMS equipment, VoIP gateways and hosted VoIP services for businesses is forecasted by Infonetics to grow from approximately \$15 billion in 2006 to approximately \$43 billion in 2011, representing a CAGR of approximately 23%. We believe our unique and patented solution provides the robust security platform required for providing on-demand secure communication links between enterprises intending to communicate securely without manually configuring the connections. We believe a standard security solution such as ours will further accelerate the adoption of IP telephony products in the market and allow enterprises to take full advantage of these rich content applications and real-time communications over the Internet, thereby significantly increasing their return on investment.

### ***Fixed-Mobile Convergence***

Fixed-mobile convergence is an environment where wireline and wireless phones work together with Internet Protocol to deliver services (voice, video, data and combinations thereof) uniformly across multiple access networks, including, among others, WiMAX, WiFi, cellular and fixed. We believe that the fixed-mobile convergence infrastructure equipment revenue will grow from approximately \$9 million in 2006 to over \$406 million in 2011, representing a CAGR of approximately 114%. Additionally, according to a thought leadership paper entitled "Road to Full Convergence" published by Fixed-Mobile Convergence Alliance, or FMCA, an alliance of leading operators representing a customer base of over 850 million customers, consumers increasingly feel the need to be connected and have real-time access to media streams, blogs and breaking news. During the past ten years, users have become increasingly technologically sophisticated and are now demanding greater functionality from the Internet. Today, the Internet is used for commerce, social networking, online dating and a number of other forms of media-rich, real-time communication and collaboration. Mobile devices like dual mode (cellular/WiFi) phones lie at the center of this transition and have become the device with the closest proximity and relationship to the user. We believe that accessing a diversity of services from a single device, anytime and anywhere, and the ability to access the same services from a range of devices, is emerging as a key market requirement. Worldwide total dual mode cellular/WiFi phone revenue was approximately \$17 billion in 2006 and is expected to grow to approximately \$76 billion in 2011, representing a CAGR of approximately 35%. The strong projected growth for converged cellular/WiFi phones and related services in enterprise and consumer market segments represents a significant opportunity for VimetX's patent portfolio, technology, and software to become the industry standard for securing real-time communication.

### ***IP Mobility***

Smartphones are multi-functional devices that handle a wide variety of business-critical applications and support increasingly complex functions including enhanced data processing, Internet access, e-mail access, calendars and scheduling, contact management and the ability to view electronic documents. Users have continual access to these applications while on the move making them an increasingly essential business tool for the mobile worker. These devices enable mobile workers to have similar functionality inside or outside the office thereby increasing employee efficiency. However, it is critical that this mobile environment have the same level of security as an enterprise's internal network. Worldwide revenue from IP mobility products like smartphones and mobile data cards is expected to grow from approximately \$26 billion in 2006 to approximately \$41 billion by 2011, representing a CAGR of approximately 10%. We believe in order to realize the full functionality of IP mobility, several challenges including security must be overcome. When users are mobile, connections and data need to cross multiple network boundaries, each of which poses a security threat. Wireless networks present unique threats because rogue users can enter the enterprise network through wireless access points that may not be sufficiently protected as part of an organization's IT security protocols. Providing authenticated access to the wireless networks and enterprise applications through the wireless domain are important requirements and represent a significant market opportunity for VimetX's patented technology and secure domain names to provide users fully authenticated secure access on a "zero-click" or "single-click" basis.

### ***Unified Communications***

The need to enhance productivity is putting increasing demand on instant access to, and the management of, rapidly expanding real-time information. Mobile collaboration, and the ability to conduct business whether inside or outside of the office, are high priorities. Business and consumer users are nomadic and expect instant access everywhere. The ability to establish multiple secure simultaneous network connections and provide IP sessions with strong security and encryption will be critical to widespread deployment of next-generation networks. A shortcoming of this new communications environment is that the various modes of communication operate independently from one another and do not integrate easily, if at all. As the number of devices grows, individual points of contact multiply and communication becomes more sophisticated and increasingly vulnerable.

The idea behind unified communications is to organize the array of communication methodologies, integrating the various fragmented ways individuals communicate today into a single communications experience, ultimately increasing utility and productivity. The basic components comprising unified communications include: a directory for storing addresses, various modes of communication with each user/contact (desk phone, mobile phone, IM, etc.), message storage for all messages regardless of communication method and secure presence of a user's status for each mode of communication (available, away, busy, etc.). Worldwide unified communications market generated approximately \$377 million in revenue in 2006 and is forecasted to grow rapidly over the next few years generating approximately \$813 million in revenue in 2011, representing a CAGR of approximately 17%. We believe the growth in unified communication products may not reach its full potential due to the lack of transparent and seamless security as users hesitate to place their presence information online for all to see and as organizations block access due to the lack of credentials verified by a neutral third party. Our solutions help address these concerns and should enable significant growth in the unified communications market.

## Our Solutions

Our software and technology solutions, including our secure domain name registry, our patents and our GABRIEL Connection Technology™ are designed to secure all types of real-time communications over the Internet. Our technology uses industry standard encryption methods with our patented DNS lookup mechanisms to create a secure communication link between users intending to communicate in real time over the Internet. Our technology can be built into network infrastructure, operating systems or silicon chips developed for a communication or computing device to secure real-time communications over the Internet between any number of devices. Our technology automatically encrypts data allowing organizations and individuals to establish communities of secure, registered users and transmit information between multiple devices, networks and operating systems. These secure network communities, which we call secure private domains, or SPDs, are designed to be fully-customizable and support rich content applications such as IM, VoIP, mobile services, streaming video, file transfer and remote desktop in a completely secure environment. Our approach is a unique and patented solution that provides the robust security platform required by these rich content applications and real-time communications over the Internet. The key benefits and features of our technology include the following:

- **Automatic and seamless to the user.** After a one-time registration, users connect securely on a “zero-click” or “single-click” basis.
- **Secure data communications.** Users create secure networks with people they trust and communicate over a secure channel.
- **Control of data at all times.** Users can secure and customize their unified communication and collaboration applications such as file sharing and remote desktop with policy-based access and secure presence information.
- **Authenticated users.** Users know they are communicating with authenticated users with secure domain names.
- **Application-agnostic technology.** Our solution provides security at the IP layer of the network by using patented DNS lookup mechanisms to make connections between secure domain names, thereby obviating the need to provide application specific security.

## Competitive Strengths

We believe the following competitive strengths will enable our success in the marketplace:

- **Unique patented technology.** We are focused on developing innovative technology for securing real-time communications over the Internet, and establishing the exclusive secure domain name registry in the United States and other key markets around the world. Our unique solutions combine industry standard encryption methods and communication protocols with our patented techniques for automated DNS lookup mechanisms. Our technology and patented approach enables users to create a secure communication link by generating secure domain names. We have a strong portfolio comprised of 12 patents in the United States and eight international patents, as well as several pending U.S. and foreign patent applications. Our portfolio includes patents and pending patent applications in the United States and other key markets that support our secure domain name registry service for the Internet.
- **Scalable licensing business model.** Our intellectual property portfolio is the foundation of our business model. We are actively engaged in commercializing our intellectual property portfolio by pursuing licensing agreements with OEMs, service providers and system integrators within the IP-telephony, mobility, fixed-mobile convergence and unified communications end-markets. We have engaged ipCapital Group to accelerate our patent and technology licensing program with customers and to expand the depth of our intellectual property portfolio, and we are actively pursuing our first licensing agreements. We believe that our licensing business model is highly scalable and has the potential to generate strong margins once we achieve significant revenue growth.

- **Highly experienced research and development team.** Our research and development team is comprised of nationally recognized network security and encryption technology scientists and experts that have worked together as a team for over ten years and, collectively, have over 120 years of experience in the field. During their careers, this team has developed several cutting-edge technologies for U.S. national defense, intelligence and civilian agencies, many of which remain critical to our national security today. Prior to joining VirnetX, our team worked for SAIC during which time they invented the technology that is the foundation of our patent portfolio, technology, and software. Based on the collective knowledge and experience of our development team, we believe that we have one of the most experienced and sophisticated groups of security experts researching vulnerability and threats to real-time communication over the Internet and developing solutions to mitigate these problems.

### **Our Strategy**

Our strategy is to become the market leader in securing real-time communications over the Internet and to establish our GABRIEL Communications Technology™ as the industry standard security platform. Key elements of our strategy are to:

- Implement a patent and technology licensing program to commercialize our intellectual property, including our GABRIEL Connection Technology™.
- Establish VirnetX as the exclusive universal registry of secure domain names and to enable our customers to act as registrars for their users and broker secure communication between users on different registries.
- Leverage our existing patent portfolio and technology to develop a suite of products that can be sold directly to end-user enterprises.

In furtherance of our strategy, in March 2008, we engaged ipCapital Group to help us support and grow our licensing business. The ipCapital Group is a leading advisor on licensing technology and intellectual property. Through our alliance with ipCapital Group, we are actively engaged in discussions with several potential customers in our target markets. ipCapital Group is led by John Cronin. Prior to founding ipCapital Group, Mr. Cronin was a distinguished inventor at IBM for 17 years where he patented 100 inventions, published over 150 technical papers, received IBM's "Most Distinguished Inventor Award," and was recognized as IBM's "Top Inventor." As a member of the senior technical staff and the prestigious IBM Academy, Mr. Cronin led an intellectual asset team that spearheaded efforts to produce and manage the development of intellectual property at IBM. Eventually known as "The IBM Patent Factory," this select group supported the division that increased IBM's annual licensing revenue from \$30 million in 1992 to more than \$1 billion in 1997 when Mr. Cronin left IBM. Since its founding in 1998, ipCapital Group has supported the licensing efforts of clients across a variety of technologies and markets, resulting in transactions representing several hundred million dollars of value.

### **License and Service Offerings**

We plan to offer a diversified portfolio of license and service offerings focused on securing real-time communications over the Internet, including:

- **VirnetX patent licensing:** Customers who want to develop their own implementation of the VirnetX code module for supporting secure domain names, or who want to use their own techniques that are covered by our patent portfolio for establishing secure communication links, will purchase a patent license. The number of patents licensed, and therefore the cost of the patent license to the customer, will depend upon which of the patents are used in a particular product or service. These licenses will typically include an initial license fee, as well as an ongoing royalty.
- **GABRIEL Connection Technology™ Software Development Kit, or SDK:** OEM customers who want to adopt the GABRIEL Connection Technology™ as their solution for establishing secure connections using secure domain names within their products will purchase an SDK license. The software development kit consists of object libraries, sample code, testing and quality assurance tools and the supporting documentation necessary for a customer to implement our technology. These tools are comprised of software for a secure domain name connection test server, a relay test server and a registration test server. Customers will pay an up-front license fee to purchase an SDK license and a royalty fee for every product shipped with the embedded VirnetX code module.



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- **Secure domain name registrar service:** Customers, including service providers, telecommunication companies, ISPs, system integrators and OEMs can purchase a license to our secure domain name registrar service. We provide the software suite and technology support to enable such customers to provision devices with secure domain names and facilitate secure connections between registered devices. This suite includes the following server software modules:
- **Registrar server software:** Enables customers to operate as a secure domain name registrar that provisions devices with secure domain names. The registrar server software provides an interface for our customers to register new virtual private domains and sub-domain names. This server module must be enrolled with the VimetX secure domain name master registry to obtain its credentials before functioning as an authorized registrar.
- **Connection server software:** Allows customers to provide connection services to enrolled devices. The connection services include registration of presence information for authenticated users and devices, presence information query request services, enforcement of policies and support for communication with peers behind firewalls.
- **Relay server software:** Allows customers to dynamically maintain connections and relay data to private IP addresses for network devices that reside behind firewalls.

Secure domain name registrar service customers will enter into a technology licensing and revenue sharing agreement with VimetX whereby we will typically receive an up-front licensing fee for the secure domain name registrar technology, as well as ongoing annual royalties for each secure domain name issued by the customer.

- **Secure domain name master registry and connection service:** As part of enabling the secure domain name registrar service, we will maintain and manage the secure domain name master registry. This service will enroll all secure domain name registrar customers and generate the credentials required to function as an authorized registrar. It also provides connection services and universal name resolution, presence information and secure connections between authorized devices with secure domain names.
- **Technical support services:** We intend to provide high-quality technical support services to licensees and customers for the rapid customization and deployment of GABRIEL Connection Technology™ in an individual customer's products and services.

Our research and development team was the team responsible for inventing the patents that form the foundation of the technology we intend to license to OEMs and service providers globally. This team has worked together for over ten years and, collectively, has over 120 years of experience in engineering and technology. We intend to leverage this experience and continue investing in research and development and, over time, expect to strengthen and expand our patent portfolio, technology, and software. While we are currently focused on securing real-time communications over the Internet and establishing the first and only secure domain name registry, we believe our existing and future intellectual property portfolio will extend to additional areas including, among others, network security and operating systems for fixed and mobile devices.

### **Customers**

We are currently focused on commercializing our technology and are actively pursuing our first licensing agreements. We intend to license our patents and our GABRIEL Connection Technology™ to original equipment manufacturers, or OEMs, within the IP-telephony, mobility, fixed-mobile convergence and unified communications markets. We also intend to license our patent portfolio, technology and software, including our secure domain name registry service, to communication service providers as well as to system integrators.

## **Marketing and Sales**

We plan to employ a leveraged, partner-oriented, marketing strategy for our patent and technology licensing program. The marketing strategy for our patent and technology licensing program will primarily be focused on OEMs. We have engaged ipCapital Group to accelerate our patent and technology licensing program with these customers and are actively pursuing our first licensing agreements.

We plan to directly market our domain name registry services to our service provider and system integrator customers. ipCapital Group is also focused on building our marketing efforts with these potential customers. Additionally, we hope to leverage our relationship with SAIC to extend our offering to departments and agencies within the federal government. SAIC is a FORTUNE 500® scientific, engineering, and technology applications company that uses its deep domain knowledge to solve problems of vital importance to the nation and the world, in national security, energy and the environment, critical infrastructure, and health.

Once we begin generating revenue, we intend to build a sales force that will be responsible for managing existing accounts and pursuing licensing and sales opportunities with new customers.

## **Competition**

We believe our technology and solutions will compete primarily against various proprietary security solutions. We group these solutions into three main categories:

- Proprietary or home-grown application specific security solutions have been developed by vendors and integrated directly into their products for our target markets including IP-telephony, mobility, fixed-mobile convergence, and unified communications. These proprietary solutions have been developed due to the lack of standardized approaches to securing real-time communications. This approach has led to corporate networks that are isolated and, as a result, restrict enterprises to using these next-generation networks within the boundaries of their private network. These solutions generally do not provide security for communications over the Internet or require network administrators to manually exchange keys and other security parameters with each destination network outside their corporate network boundary. The cost-savings and other benefits of IP-based real-time communications are significantly limited by this approach to securing real-time communications.
- A session border controller, or SBC, is a device used in networks to exert control over the signaling and media streams involved in establishing, conducting and terminating VoIP calls. Signaling protocols such as SIP and XMPP, transfer information including endpoint IP addresses and port numbers in a manner that prevents this information from being seen by a traditional firewall or network address translation, or NAT, device, and reaching the intended destination. SBCs are used in physical networks to address these limitations and enable real-time session traffic to cross the boundaries created by firewalls and other NAT devices and enable VoIP calls to be established successfully. However, SBCs must decrypt and analyze every single data packet for the information to be transmitted successfully, thereby preventing end-to-end encryption. This network design results in SBCs becoming a single point of congestion on the network, as well as a single point of failure. SBCs are also limited to the physical network they secure.
- SIP firewalls, or SIP-aware firewalls, and application layer gateways, manage and protect the traffic, flow and quality of VoIP and other SIP-related communications. They perform real-time network address translation and dynamic firewall functions and support multiple signaling protocols, and media functionality, allowing secure interconnection and the flow of IP media streams across multiple networks. While SIP firewalls assist in analyzing SIP traffic transmitted over the corporate network to filter out various threats, they do not necessarily encrypt the traffic. As a result, this traffic is not entirely secure from end-to-end nor is it protected against threats like man-in-middle and eavesdropping.

## Intellectual Property and Patent Rights

Our intellectual property is primarily comprised of trade secrets, patented know-how, issued and pending patents and technological innovation.

We have a strong portfolio comprised of 12 patents in the United States and eight international patents, as well as several pending U.S. and foreign patent applications. Our patent portfolio is primarily focused on securing real-time communications over the Internet, as well as related services such as the establishment and maintenance of a secure domain name registry. Our software and technology solutions also have additional applications in operating systems and network security.

We have included a list of our U.S. patents below. Each patent below is publicly accessible on the Internet website of the U.S. Patent and Trademark Office at [www.uspto.gov](http://www.uspto.gov). The various terms of our issued U.S. and foreign patents will expire during the period from 2019 to 2024.

### U.S. Patent

#### Number

#### Link to Patent

#### Title of Patent

6,502,135	Agile network protocol for secure communications with assured system availability
6,618,761	Agile network protocol for secure communications with assured system availability
6,826,616	Method for establishing secure communication link between computers of virtual private network
6,834,310	Preventing packet flooding of a computer on a computer network
6,839,759	Method for establishing secure communication link between computers of virtual private network without user entering any cryptographic information
6,907,473	Agile network protocol for secure communications with assured system availability
7,010,604	Agile network protocol for secure communications with assured system availability
7,133,930	Agile network protocol for secure communications with assured system availability
7,188,180	Method for establishing secure communication link between computers of virtual private network
7,209,479	Third party VPN certification
7,418,504	Agile network protocol for secure communications using secure domain names
7,490,151	Establishment of a secure communication link based on a domain name service (DNS) request

*Notwithstanding anything to the contrary set forth in any of the Company's filings under the Securities Act of 1933 or the Securities Exchange Act of 1934 that might incorporate future filings, the information set forth on the United States Patent and Trademark Office, or the USPTO Website, shall not be deemed to be a part of or incorporated by reference into any such filings. The Company does not warrant the accuracy or completeness, or adequacy of the USPTO Website, and expressly disclaims liability for errors or omissions on such website.*

### Assignment of Patents

Most of our issued patents were originally acquired from SAIC pursuant to an assignment agreement by and between VimetX and SAIC dated December 21, 2006, and a patent license and assignment agreement by and between VimetX and SAIC dated August 12, 2005, as amended on November 2, 2006, including documents prepared pursuant to the November amendment, and as further amended on March 12, 2008. VimetX recorded the assignment from SAIC with the U.S. Patent and Trademark Office on December 21, 2006.

Key terms of these agreements are as follows:

- **Patent assignment.** SAIC unconditionally and irrevocably conveyed, transferred, assigned and quitclaimed all its right, title and interest in and to the patents and patent applications, as specifically set forth on Exhibit A to the assignment document recorded with the U.S. Patent and Trademark Office, including, without limitation, the right to sue for past infringement.
- **License to SAIC outside the field of use.** On November 2, 2006, we granted to SAIC an exclusive, royalty free, fully paid, perpetual, worldwide, irrevocable, sublicensable and transferable right and license permitting SAIC and its assignees to make, have made, import, use, offer for sale, and sell products and services covered by, and to make improvements to, the patents and patent applications we acquired from SAIC, solely outside our field of use. We have, and retain, all right, title and interest to all our patents within our field of use. Our field of use is defined as the field of secure communications in the following areas: virtual private networks, or VPNs; secure VoIP; electronic mail, or e-mail; video conferencing; communications logging; dynamic uniform resource locators, or URLs; denial of service; prevention of functional intrusions; IP hopping; voice messaging and unified messaging; live voice and IP PBXs; voice web video conferencing and collaboration; IM; minimized impact of viruses; and secure session initiation protocol or SIP. Our field of use is not limited by any predefined transport mode or medium of communication (for example, wire, fiber, wireless, or mixed medium). On March 12, 2008, SAIC relinquished the November 2, 2006, exclusive grant back license outside our field of use, as well as any right to obtain such exclusive license in the future. Effective March 12, 2008, we granted to SAIC a non-exclusive, royalty free, fully paid, perpetual, worldwide, irrevocable, sublicensable and transferable right and license permitting SAIC and its assignees to make, have made, import, use, offer for sale, and sell products and services covered by, and to make improvements to, the patents and patent applications we acquired from SAIC, solely outside our field of use.

- **Compensation obligations.** As consideration for the assignment of the patents and for the rights we obtained from SAIC as a result of the March 12, 2008 amendment, we are required to make payments to SAIC based on the revenue generated from our ownership or use of the patents assigned to us by SAIC.
  - Our compensation obligation includes payment of royalties, in an amount equal to (a) 15% of all gross revenues generated by us in our field of use less (1) trade, quantity and cash discounts allowed, (2) commercially reasonable commissions, discounts, refunds, rebates, chargebacks, retroactive price adjustments and other allowances which effectively reduce the net selling price, and which are based on arms length terms and are customary and standard in VimetX's industry, and (3) actual product returns and allowances; (b) 15% of all non-license gross revenues generated by us outside our field of use less (1) trade, quantity and cash discounts allowed, (2) commercially reasonable commissions, discounts, refunds, rebates, chargebacks, retroactive price adjustments and other allowances which effectively reduce the net selling price, and which are based on arms length terms and are customary and standard in VimetX's industry, and (3) actual product returns and allowances; and (c) 50% of all license revenues generated by us outside our field of use less (1) trade, quantity and cash discounts allowed, (2) commercially reasonable commissions, discounts, refunds, rebates, chargebacks, retroactive price adjustments and other allowances which effectively reduce the net selling price, and which are based on arms length terms and are customary and standard in VimetX's industry, and (3) actual product returns and allowances.
  - Royalty payments are calculated based on each quarter and payment is due within 30 days following the end of each quarter.
  - Beginning 18 months after January 1, 2007, we must make a minimum guaranteed annual royalty payment of \$50,000.
  - The maximum cumulative royalty paid in respect to our revenue-generating activities in our field of use shall be no more than \$35 million.
  - In addition to the royalties, in the circumstances and subject to the limitations specified in the November amendment, SAIC shall be entitled to receive 10% of any proceeds, revenues, monies or any other form of consideration paid for the acquisition of VimetX by Microsoft or any other party alleged to be infringing the patents or patent applications we acquired from SAIC, up to a maximum amount of \$35 million. Any such payments to SAIC shall be credited against the \$35 million maximum cumulative royalty payable with respect to our revenue-generating activities in our field of use.
  - In the event that VimetX receives any proceeds, recovery or other form of compensation (other than acquisition proceeds) as a result of any action or proceeding brought by VimetX against Microsoft or certain other alleged infringing companies to resolve a claim of infringement or enforcement relating to the patents and patent applications we acquired from SAIC, or as a result of negotiations with such entities, as further consideration for the assignment of the patents, in lieu of any amounts otherwise owing to SAIC we must pay to SAIC 35% of the excess of such proceeds over all costs incurred in connection with any such litigation, without a cap. Any payment to SAIC of amounts with respect to such proceeds shall be credited against the \$35 million maximum cumulative royalty payable with respect to our revenue-generating activities in our field of use.

- In the event that VimetX receives any proceeds, recovery or other form of compensation as a result of any action or proceeding brought by VimetX against parties other than Microsoft and certain other alleged infringing companies, with respect to which VimetX is required to notify SAIC of infringement under the terms of the November amendment to resolve a claim of infringement or enforcement relating to the patents and patent applications we acquired from SAIC, or as a result of negotiations with such entities (other than acquisition proceeds) as further consideration for the assignment of the patents, in lieu of any amounts otherwise owing to SAIC we must pay to SAIC 25% of the excess of such proceeds over all costs incurred in connection with any such litigation, without a cap. Any payment to SAIC of amounts with respect to such proceeds shall be credited against the \$35 million maximum cumulative royalty payable with respect to our revenue-generating activities in our field of use.
- **Reversion to SAIC upon breach or default.** We must convey, transfer, assign and quitclaim to SAIC all of our right, title and interest in and to the patents or patent applications we acquired from SAIC, upon the first occurrence of the following reversion events:
  - our failure to pay SAIC an aggregate cumulative amount of at least \$7.5 million within seven years after January 1, 2007;
  - our failure to pay the \$50,000 minimum annual royalty that has not been cured within 90 days after our receipt of written notice of such failure; or
  - for the period prior to the date of our full payment of the \$35 million maximum cumulative royalty, any termination of the August 2005 agreement with SAIC, as amended.

If a reversion event occurs due to our failure to pay SAIC an aggregate cumulative amount of at least \$7.5 million within seven years after January 1, 2007, then we will receive from SAIC a non-exclusive license to the reverting patents in our field of use.

- **Rights to bring and control actions for infringement and enforcement.** In addition to the exclusive right to bring and control any action or proceeding with respect to infringement or enforcement of our patents, and to collect damages and fees for past, present and future infringement, both in and outside of our field of use, we also have the first right to negotiate with or bring a lawsuit against any and all third parties for purposes of enforcing our patents, regardless of the field of use.
- **Security agreement.** We granted SAIC a security interest in some of our intellectual property, including the patents and patent applications we obtained from SAIC, to secure our payment obligations to SAIC described above.

#### **Government Regulation**

The laws governing online secure communications remain largely unsettled, even in areas where there has been legislative action. It may take years to determine whether and how existing laws governing intellectual property, privacy and libel apply to online media. Such legislation may interfere with the growth in use of online secure communications and decrease the acceptance of online secure communications as a viable solution, which could adversely affect our business.

Due to the Internet's popularity and increasing use, new laws regulating secure communications may be adopted. These laws and regulations may cover, among other things, issues relating to privacy, pricing, taxation, telecommunications over the Internet, content, copyrights, distribution and quality of products and services. We intend to comply with all new laws and regulations as they are adopted.

The U.S. government has historically controlled the authoritative domain name system, or DNS, root server since the inception of the Internet. On July 1, 1997, the President of the United States directed the U.S. Secretary of Commerce to privatize the management of the domain name system in a manner that increases competition and facilitates international participation in its management.

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On September 29, 2006, the U.S. Department of Commerce extended its delegation of authority by entering into a new agreement with the Internet Corporation for Assigned Names and Numbers, or ICANN, a California non-profit corporation headquartered in Marina Del Rey, California. ICANN is responsible for managing the accreditation of registry providers and registrars that manage the assignment of top level domain names associated with the authoritative DNS root directory. Although it is possible to create and manage other DNS root directories privately without accreditation from ICANN, the possibility of conflicting name and number assignments makes it less likely that users would widely adopt a top level domain name associated with an alternative DNS root directory provided by a non-ICANN-accredited registry service.

On June 26, 2008, ICANN announced that it will be relaxing its prior position and will begin to issue generic top level domain names, or gTLDs, more broadly than it had previously. ICANN expects to begin to take applications for gTLDs in April or May of 2009 with an application fee of \$100,000 or more per application. ICANN expects the first of these customized gTLDs to be issued in the fourth quarter of 2009.

We are currently evaluating whether we will apply to become an ICANN-accredited registry provider with respect to one or more customized gTLDs, or create our own alternative DNS root directory to manage the assignment of non-standard secure domain names. We have not yet begun discussions with ICANN and we cannot assure you that we will be successful in obtaining ICANN accreditation for our registry service on terms acceptable to us or at all. Whether or not we obtain accreditation from ICANN, we will be subject to the ongoing risks arising out of the delegation of the U.S. government's responsibilities for the domain name system to the U.S. Department of Commerce and ICANN and the evolving government regulatory environment with respect to domain name registry services.

### **Employees**

As of December 31, 2008, we had 12 full-time employees.

### **Corporate Overview and History**

PASW, Inc. was incorporated in the State of California in November 1992. PASW, Inc. reincorporated in the State of Delaware in March 2007. From inception until January 2003, PASW, Inc. was engaged in the business of developing and licensing software that enabled Internet and web based communications. In January 2003, PASW, Inc. sold all of its operating assets and became a publicly traded company with limited operations.

VimetX, Inc., which we refer to throughout this Annual Report on Form 10-K as VimetX, was incorporated in the State of Delaware in August 2005. In November 2006, VimetX acquired certain patents from SAIC. In July 2007, we effected a reverse merger between PASW, Inc. and VimetX, which became our principal operating subsidiary. As a result of this merger, the former security holders of VimetX came to own a majority of our outstanding common stock. On October 29, 2007, we changed our name from PASW, Inc. to VimetX Holding Corporation.

### **Available Information**

We file or furnish various reports, such as registration statements, periodic and current reports, proxy statements and other materials with the SEC. Our Internet website address is [www.vimetx.com](http://www.vimetx.com). You may obtain, free of charge on our Internet website, copies of our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. The information we post is intended for reference purposes only; none of the information posted on our website is part of this report or incorporated by reference herein.

In addition to the materials that are posted on our website, you may read and copy any materials we file with the SEC at the SEC's Public Reference Room at 100 F Street, NE, Washington, DC 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC also maintains an Internet site that contains reports, proxy and other information statements, and other information regarding issuers, including us, that file electronically with the SEC. The Internet address of the SEC's Internet site is <http://www.sec.gov>.

**Item 1A. Risk Factors.**

*You should carefully consider the following material risks in addition to the other information set forth in Annual Report on Form 10-K before making any investment in the offered securities. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we currently believe to be immaterial may also adversely affect our business. If any of these risk factors occurs, you could lose substantial value or your entire investment in the offered securities.*

**Risks Related To Existing and Future Litigation**

***We have commenced legal proceedings against Microsoft, and we expect such litigation to be time-consuming and costly, which may adversely affect our financial condition and our ability to operate our business.***

On February 15, 2007, we initiated a lawsuit by filing a complaint against Microsoft in the United States District Court for the Eastern District of Texas, Tyler Division, pursuant to which we allege that Microsoft infringes two of our patents regarding the creation of virtual private networks, or VPNs. We seek damages and injunctive relief. On April 5, 2007, we filed an amended complaint, pursuant to which we allege that Microsoft infringes a third patent. On February 17, 2009, a Markman hearing on claim construction was conducted and the parties are currently awaiting the Court's order with respect to the hearing. We anticipate that these legal proceedings may continue for several years and may require significant expenditures for legal fees and other expenses. The time and effort required of our management to effectively pursue the Microsoft lawsuit may adversely affect our ability to operate our business, since time spent on matters related to the lawsuit will take away from the time spent on managing and operating our business. Microsoft has counterclaimed for declarations that the three patents are not infringed, are invalid and are unenforceable. If Microsoft's counterclaims are successful, they may preclude our ability to commercialize our initial products. Additionally, we anticipate that our legal fees will be material and will negatively impact our financial condition and results of operations and may result in our inability to continue our business.

***While we believe Microsoft infringes our patents, we can provide no assurance that we will be successful in our lawsuit.***

We believe that Microsoft infringes on three of our patents, but obtaining and collecting a judgment against Microsoft may be difficult or impossible. Patent litigation is inherently risky and the outcome is uncertain. Microsoft is a large, well-financed company with substantially greater resources than us. We believe that Microsoft will devote a substantial amount of resources in an attempt to prove that either their products do not infringe our patents or that our patents are not valid and are unenforceable. At this time, we cannot predict the outcome of this litigation.

***We are devoting a substantial amount of our financial and management resources to the Microsoft litigation, and if we are unsuccessful in this lawsuit, our financial condition may be so adversely affected, we may not survive.***

Currently, we are devoting substantial time, effort and financial resources to our lawsuit against Microsoft. We are a development stage company with no finished product, and, although our business strategy is focused primarily on bringing patented products to market, our business strategy also depends greatly on obtaining a judgment in our favor from the courts and collecting such judgment before our financial resources are depleted. In the event we are not awarded and do not subsequently obtain monetary and injunctive relief, we may not have enough financial resources to continue our operations.

***The burdens of being a public company may adversely affect our ability to pursue the Microsoft litigation.***

As a public company, our management must devote substantial time, attention and financial resources to comply with U.S. securities laws. This may have a material adverse affect on management's ability to effectively pursue the Microsoft litigation as well as our other business initiatives. In addition, our disclosure obligations under U.S. securities laws require us to disclose information publicly that will be available to Microsoft as well as any other future litigation opponents. We may, from time to time, be required to disclose information that will have a material adverse affect on our litigation strategies. This information may enable our litigation opponents to develop effective litigation strategies that are contrary to our interests.

*We may commence additional legal proceedings against third parties who we believe are infringing on our intellectual property rights, and if we are forced to litigate to defend our intellectual property rights, or to defend claims by third parties against us relating to intellectual property rights, legal fees and court injunctions could adversely affect our financial condition or end our business.*

Disputes regarding the ownership of technologies and intellectual property rights are common and we may have intellectual property infringement claims against other parties in addition to our claims against Microsoft. If we decide to commence actions against any additional parties, doing so may be expensive and time-consuming, which may adversely affect our financial condition and results of operations. Moreover, there can be no assurance that we would be successful in these additional legal proceedings and the existence and outcome of any such litigation could harm our business. In addition, commencing lawsuits may lead to potential counterclaims which may preclude our ability to develop and commercialize our initial products.

#### **Risks Related to Our Business and Our Industry**

*We are a development stage company with virtually no revenues.*

We are a development stage company with a very small amount of revenue and do not expect to generate additional revenues unless and until our patent portfolio, or part of it, is commercialized. We anticipate that our existing cash and cash equivalents are insufficient to fund our operations for longer than through the end of our second quarter of 2009. We need to raise additional capital to fund our operations and our litigation against Microsoft and there can be no assurance that we will be successful in doing so on acceptable terms or at all. Inability to generate sufficient cash flow or raise other funds to meet our expenses, obligations and sustain our operations raises substantial doubt about our ability to continue as a going concern. See the "Liquidity and Capital Resources" section in this Annual Report for additional information.

*We anticipate incurring operating losses and negative cash flows for the foreseeable future resulting in uncertainty of future profitability and limitations on our operations.*

We anticipate that we will incur operating losses and negative cash flows in the foreseeable future, and we will accumulate increasing deficits as we increase our expenditures for:

- our lawsuit against Microsoft;
- infrastructure;
- sales and marketing;
- research and development;
- personnel; and
- general business enhancements.

We need to significantly increase our revenue if we are to attain profitability and there is no assurance that we will be able to do so. As discussed in the notes to the consolidated financial statements included in this Annual Report, in the event that we are unable to achieve profitability or raise sufficient funding to cover our losses in the near term, we will be unable to meet our expenses and obligations as they come due, and this raises substantial doubts as to our ability to continue as a going concern. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.



***Our business plan for commercializing our patents and technology is new and unproven, and therefore we can provide no assurance that we will be successful in pursuing it.***

We intend to develop products to provide a security platform for real-time communications; however, this is not a defined market. We expect to depend on our intellectual property licensing fees for the majority of our revenues. Our ability to generate licensing fees is highly dependent on mainstream market adoption of real-time communications based on SIP or using DNS lookup protocols as well as customer adoption of our GABRIEL Communication Technology™ and our secure domain name registry. We cannot assure you that customers will adopt our products and services, or that we will succeed in building a profitable business based on our business plan.

***We may or may not be able to capitalize on potential market opportunities related to our licensing strategy or our patent portfolio.***

Our business strategy calls for us to enter into licensing relationships with the leading companies in our target market in order to reach a larger end-user base than we could reach through direct sales and marketing efforts. We have engaged ipCapital Group to help develop our licensing strategy and to introduce the Company to five potential strategic licensees of the Company's technology. In connection with this engagement, we agreed to pay ipCapital Group 10% of the royalties of each resulting licensing arrangement, up to an aggregate maximum of \$2 million per licensee, or \$10 million in the aggregate. There can be no assurance that we will be able to capitalize on the potential market opportunity. Our inability to generate licensing revenues associated with the potential market opportunity could result from a number of factors, including, but not limited to:

- our capital resources may be insufficient;
- our management team may not have sufficient bandwidth to successfully capitalize on all of the opportunities identified by ipCapital Group;
- we may not be successful in entering into licensing relationships with our targeted customers on commercially acceptable terms; and
- the validity of our patents underlying the licensing opportunity is currently being challenged in our litigation against Microsoft.

***Our business greatly depends on the growth of IM, VoIP, mobile services, streaming video, file transfer and remote desktop and other next-generation Internet-based applications.***

We cannot assure you that next-generation Internet-based applications such as instant messaging, or IM, voice over Internet protocol, or VoIP, mobile services, streaming video, file transfer and remote desktop will continue to gain widespread market acceptance. The Internet may ultimately prove not to be a viable commercial marketplace for such applications for a number of reasons, including:

- unwillingness of consumers to shift to VoIP and use other such next-generation Internet-based applications;
- refusal to purchase security products to secure information transmitted through such applications;
- perception by the licensees of unsecure communication and data transfer;
- lack of concern for privacy by licensees and users;
- limitations on access and ease of use;
- congestion leading to delayed or extended response times;
- inadequate development of Internet infrastructure to keep pace with increased levels of use; and
- increased government regulations.

***If the market for IM, VoIP, mobile services, streaming video, file transfer and remote desktop does not grow as anticipated, our business would be adversely affected.***

The success of our products that secure IM, VoIP, mobile services, streaming video, file transfer and remote desktop, among other real-time communications applications, depends on the growth in the number of users, which in turn depends on the Internet gaining more widespread acceptance as the basis for these real-time communications applications. These real-time communications applications are still in early stages of market acceptance and we cannot assure you that they will continue to develop a broader audience. For example, potential new users may view VoIP as unattractive relative to traditional telephone services for a number of reasons, including the need to purchase computer headsets or the perception that the price advantage for VoIP is insufficient to justify the perceived inconvenience.

***While the use of IM and other next-generation Internet-based applications has grown rapidly in personal and professional use, there can be no assurance that users will pay to secure their use of such applications.***

Many services such as Microsoft, Yahoo! and America Online offer IM free of charge. However, security solutions for these services are not free, and OEMs may not want to adopt such security solutions if users of IM do not see the value and do not want to pay for such security solutions. If personal and professional users of IM and other next-generation Internet-based solutions do not want to pay for the security solutions, we will have difficulty marketing and selling our products and technologies.

***We expect that we will experience long and unpredictable sales cycles, which may impact our quarterly operating results.***

We expect that our sales cycles will be long and unpredictable due to a number of uncertainties such as:

- the need to educate potential customers about our patent rights and our product and service capabilities;
- customers' willingness to invest potentially substantial resources and modify their network infrastructures to take advantage of our products;
- customers' budgetary constraints;
- the timing of customers' budget cycles; and
- delays caused by customers' internal review processes.

***We expect that we will be substantially dependent on a concentrated number of customers. If we are unable to establish, maintain or replace our relationships with customers and develop a diversified customer base, our revenues may fluctuate and our growth may be limited.***

We expect that for the foreseeable future, a significant portion of our revenues will be generated from a limited number of customers. There can be no guarantee that we will be able to obtain such customers, or if we do so, to sustain our revenue levels from these customers. If we cannot establish, maintain or replace the limited group of customers that we anticipate will generate a substantial majority revenues, or if they do not generate revenues at the levels or at the times that we anticipate, our ability to maintain or grow our revenues will be adversely affected.

***If we do not successfully develop our planned products and services in a cost-effective manner to customer demand in the rapidly evolving market for Internet and IP-based communications services, our business may fail.***

The market for communications services is characterized by rapidly changing technology, evolving industry standards, changes in customer needs and frequent new service and product introductions. We are currently focused on developing products to provide security solutions for real-time communications. Our future success will depend, in part, on our ability to use new technologies effectively, to continue to develop our technical expertise, to enhance our existing services and to develop new services that meet changing customer needs on a timely and cost-effective basis. We may not be able to adapt quickly enough to changing technology, customer requirements and industry standards. If we fail to use new technologies effectively, to develop our technical expertise and new services, or to enhance existing services on a timely basis, either internally or through arrangements with third parties, our product and service offerings may fail to meet customer needs, which would adversely affect our revenues and prospects for growth.

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In addition, if we are unable, for technological, legal, financial or other reasons, to adapt in a timely manner to changing market conditions or customer requirements, we could lose customers, strategic alliances and market share. Sudden changes in user and customer requirements and preferences, the frequent introduction of new products and services embodying new technologies and the emergence of new industry standards and practices could render our existing products, services and systems obsolete. The emerging nature of products and services in the technology and communications industry and their rapid evolution will require that we continually improve the performance, features and reliability of our products and services. Our success will depend, in part, on our ability to:

- design, develop, launch and/or license our planned products, services and technologies that address the increasingly sophisticated and varied needs of our prospective customers; and
- respond to technological advances and emerging industry standards and practices on a cost-effective and timely basis.

The development of our planned products and services and other patented technology involves significant technological and business risks and requires substantial expenditures and lead time. We may be unable to use new technologies effectively. Updating our technology internally and licensing new technology from third-parties may also require us to incur significant additional expenditures.

***If our products do not gain market acceptance, we may not be able to fund future operations.***

A number of factors may affect the market acceptance of our planned products or any other products we develop or acquire, including, among others:

- the price of our products relative to other products that seek to secure real-time communication;
- the perception by users of the effectiveness of our products;
- our ability to fund our sales and marketing efforts; and
- the effectiveness of our sales and marketing efforts.

If our products do not gain market acceptance, we may not be able to fund future operations, including the development of new products and/or our sales and marketing efforts for our current products, which inability would have a material adverse effect on our business, financial condition and operating results.

***Our products are highly technical and may contain undetected errors, which could cause harm to our reputation and adversely affect our business.***

Our products are highly technical and complex and, when deployed, may contain errors or defects. In addition, we rely on third parties for software development and technology services, and there may be errors in the development processes used by our third party counterparts that may adversely affect our end products. Despite testing, some errors in our products may only be discovered after a product has been installed and used by customers. Any errors or defects discovered in our products after commercial release could result in failure to achieve market acceptance, loss of revenue or delay in revenue recognition, loss of customers and increased service and warranty cost, any of which could adversely affect our business, operating results and financial condition. In addition, we could face claims for product liability, tort or breach of warranty, including claims relating to changes to our products made by our channel partners. The performance of our products could have unforeseen or unknown adverse effects on the networks over which they are delivered as well as on third-party applications and services that utilize our services, which could result in legal claims against us, harming our business. Furthermore, we expect to provide implementation, consulting and other technical services in connection with the implementation and ongoing maintenance of our products, which typically involves working with sophisticated software, computing and communications systems. We expect that our contracts with customers will contain provisions relating to warranty disclaimers and liability limitations, which may not be upheld. Defending a lawsuit, regardless of its merit, is costly and may divert management's attention and adversely affect the market's perception of us and our products. In addition, if our business liability insurance coverage proves inadequate or future coverage is unavailable on acceptable terms or at all, our business, operating results and financial condition could be adversely impacted.

***Malfunctions of third-party communications infrastructure, hardware and software exposes us to a variety of risks we cannot control.***

In addition, our business will also depend upon the capacity, reliability and security of the infrastructure owned by third parties that we will use to deploy our offerings. We have no control over the operation, quality or maintenance of a significant portion of that infrastructure or whether or not those third parties will upgrade or improve their equipment. We depend on these companies to maintain the operational integrity of our connections. If one or more of these companies is unable or unwilling to supply or expand its levels of service to us in the future, our operations could be severely interrupted. Also, to the extent the number of users of networks utilizing our future products suddenly increases, the technology platform and secure hosting services which will be required to accommodate a higher volume of traffic may result in slower response times or service interruptions. System interruptions or increases in response time could result in a loss of potential or existing users and, if sustained or repeated, could reduce the appeal of the networks to users. In addition, users depend on real-time communications; outages caused by increased traffic could result in delays and system failures. These types of occurrences could cause users to perceive that our solution does not function properly and could therefore adversely affect our ability to attract and retain licensees, strategic partners and customers.

***System failure or interruption or our failure to meet increasing demands on our systems could harm our business.***

The success of our license and service offerings will depend on the uninterrupted operation of various systems, secure data centers and other computer and communication networks that we establish. To the extent the number of users of networks utilizing our future products suddenly increases, the technology platform and hosting services which will be required to accommodate a higher volume of traffic may result in slower response times, service interruptions or delays or system failures. Our systems and operations will also be vulnerable to damage or interruption from:

- power loss, transmission cable cuts and other telecommunications failures;
- damage or interruption caused by fire, earthquake, and other natural disasters;
- computer viruses or software defects; and
- physical or electronic break-ins, sabotage, intentional acts of vandalism, terrorist attacks and other events beyond our control.

System interruptions or failures and increases or delays in response time could result in a loss of potential or existing users and, if sustained or repeated, could reduce the appeal of the networks to users. These types of occurrences could cause users to perceive that our solution does not function properly and could therefore adversely affect our ability to attract and retain licensees, strategic partners and customers.

Any significant problem with our systems or operations could result in lost revenue, customer dissatisfaction or lawsuits against us. A failure in the operation of our secure domain name registration system could result in the inability of one or more registrars to register and maintain secure domain names for a period of time. A failure in the operation or update of the master directory that we plan to maintain could result in deletion or discontinuation of assigned secure domain names for a period of time. The inability of the registrar systems we establish, including our back office billing and collections infrastructure, and telecommunications systems to meet the demands of an increasing number of secure domain name requests could result in substantial degradation in our customer support service and our ability to process registration requests in a timely manner.

***If we experience security breaches, we could be exposed to liability and our reputation and business could suffer.***

We will retain certain confidential customer information in our secure data centers and secure domain name registry. It will be critical to our business strategy that our facilities and infrastructure remain secure and are perceived by the marketplace to be secure. Our secure domain name registry operations will also depend on our ability to maintain our computer and telecommunications equipment in effective working order and to reasonably protect our systems against interruption, and potentially depend on protection by other registrars in the shared registration system. The secure domain name servers that we will operate will be critical hardware to our registry services operations. Therefore, we expect to have to expend significant time and money to maintain or increase the security of our facilities and infrastructure.

Security technologies are constantly being tested by computer professionals, academics and “hackers.” Advances in the techniques for attacking security solutions could make some or all of our products obsolete or unmarketable. Likewise, if any of our products are found to have significant security vulnerabilities, then we may need to dedicate engineering and other resources to eliminate the vulnerabilities and to repair or replace products already sold or licensed to our customers. Despite our security measures, our infrastructure may be vulnerable to physical break-ins, computer viruses, attacks by hackers or similar disruptive problems. It is possible that we may have to expend additional financial and other resources to address such problems. Any physical or electronic break-in or other security breach or compromise of the information stored at our secure data centers and domain name registration systems may jeopardize the security of information stored on our premises or in the computer systems and networks of our customers. In such an event, we could face significant liability and customers could be reluctant to use our services. Such an occurrence could also result in adverse publicity and therefore adversely affect the market’s perception of the security of electronic commerce and communications over IP networks as well as of the security or reliability of our services.

***We may incur significant expenses and damages because of liability claims.***

An actual or perceived breach of our security solutions could result in a product liability claim against us. A substantial product liability claim against us could harm our operating results and financial condition. In addition, any actual or perceived breach of our security solution, whether or not caused by the failure of one of our products, could hurt our reputation and cause potential customers to turn to our competitors’ products.

***Our ability to sell our solutions will be dependent on the quality of our technical support, and our failure to deliver high-quality technical support services could have a material adverse effect on our sales and results of operations.***

If we do not effectively assist our customers in deploying our products, succeed in helping our customers quickly resolve post-deployment issues and provide effective ongoing support, or if potential customers perceive that we may not be able to achieve to the foregoing, our ability to sell our products would be adversely affected, and our reputation with potential customers could be harmed. In addition, as we expand our operations internationally, our technical support team will face additional challenges, including those associated with delivering support, training and documentation in languages other than English. As a result, our failure to deliver and maintain high-quality technical support services to our customers could result in customers choosing to use our competitors’ products instead of ours in the future.

***There has been increased competition for security solutions in the real-time communications industry, as more companies seek to provide products and services similar to our proposed products and services, and because larger and better-financed competitors may affect our ability to operate our business and achieve profitability, our business may fail.***

We expect competition for our products and services to be intense. We expect to compete directly against other companies offering similar security products and services that will compete directly with our proposed products and services. We also expect that we will compete against established vendors within the IP-telephony, mobility, fixed-mobile convergence and unified communications markets. These companies may incorporate other competitive technologies into their product offerings, whether developed internally or by third parties. For the foreseeable future, substantially all of our competitors are likely to be larger, better-financed companies that may develop products superior to our proposed products, which could create significant competitive advantages for those companies. Our future success depends on our ability to compete effectively with our competitors. As a result, we may have difficulty competing with larger, established competitor companies. Generally, these competitors have:

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- substantially greater financial, technical and marketing resources;
- a larger customer base;
- better name recognition; and
- more expansive product offerings.

These competitors are likely to command a larger market share than us, which may enable them to establish a stronger competitive position, in part, through greater marketing opportunities. Further, our competitors may be able to respond more quickly to new or emerging technologies and changes in user preferences and to devote greater resources to developing and operating networks of affinity websites. These competitors may develop products or services that are comparable or superior. If we fail to address competitive developments quickly and effectively, we may not be able to remain a viable entity.

***If we are not able to adequately protect our patented rights, our operations would be negatively impacted.***

Our ability to compete largely depends on the superiority, uniqueness and value of our technology and intellectual property. To protect our intellectual property rights, we rely on a combination of patent, trademark, copyright and trade secret laws, confidentiality agreements with our employees and third parties, and protective contractual provisions. Further, we can give no assurances that infringement or invalidity claims (or claims for indemnification resulting from infringement claims) will not be asserted or prosecuted against us or that any such assertions or prosecutions will not materially adversely affect our business. Regardless of whether any such claims are valid or can be successfully asserted, defending against such claims could cause us to incur significant costs and could divert resources away from our other activities. In addition, assertion of infringement claims could result in injunctions that prevent us from distributing our products. Despite these efforts, any of the following may reduce the value of our intellectual property:

- our applications for patents, trademarks and copyrights relating to our business may not be granted and, if granted, may be challenged or invalidated;
- issued trademarks, copyrights, or patents may not provide us with any competitive advantages;
- our efforts to protect our intellectual property rights may not be effective in preventing misappropriation of our technology; or
- our efforts may not prevent the development and design by others of products or technologies similar to or competitive with, or superior to those we develop.

In addition, we may not be able to effectively protect our intellectual property rights in certain foreign countries where we may do business in the future or from which competitors may operate. While we have numerous pending international patents, obtaining such patents will not necessarily protect our technology or prevent our international competitors from developing similar products or technologies. Our inability to adequately protect our patented rights would have a negative impact on our operations and revenues.

In addition, legal standards relating to the validity, enforceability, and scope of protection of intellectual property rights in Internet-related businesses are uncertain and still evolving. Because of the growth of the Internet and Internet related businesses, patent applications are continuously and simultaneously being filed in connection with Internet-related technology. There are a significant number of U.S. and foreign patents and patent applications in our areas of interest, and we believe that there has been, and is likely to continue to be, significant litigation in the industry regarding patent and other intellectual property rights.

***If we fail to meet our obligations to SAIC, we may lose our rights to key technologies on which our business depends.***

Our business depends on our rights to and under the patents we obtained from SAIC. Our agreements with SAIC impose various obligations on us, including payment obligations and minimum royalties that we must pay to SAIC. If SAIC believes that we have failed to meet these obligations, SAIC could seek to limit or reacquire the assigned patent rights, which could lead to costly and time-consuming litigation and, potentially, a loss of our rights in these patents. During the period of any such litigation, our ability to carry out the development and commercialization of potential products could be significantly and negatively affected. The loss or restriction of our rights in our patents would result in our inability to continue our business.

***When we attempt to implement our secure domain name registry services business, we may be subject to government and industry regulation and oversight which may impede our ability to achieve our business strategy.***

The U.S. government has historically controlled the authoritative domain name system, or DNS, root server since the inception of the Internet. On July 1, 1997, the President of the United States directed the U.S. Secretary of Commerce to privatize the management of the domain name system in a manner that increases competition and facilitates international participation in its management.

On September 29, 2006, the U.S. Department of Commerce extended its delegation of authority by entering into a new agreement with the Internet Corporation for Assigned Names and Numbers, or ICANN, a California non-profit corporation headquartered in Marina Del Rey, California. ICANN is responsible for managing the accreditation of registry providers and registrars that manage the assignment of top level domain names associated with the authoritative DNS root directory. Although other DNS root directories are possible to create and manage privately without accreditation from ICANN, the possibility of conflicting name and number assignments makes it less likely that users would widely adopt a top level domain name associated with an alternative DNS root directory provided by a non-ICANN-accredited registry service.

On June 26, 2008, ICANN announced that it will be relaxing its prior position and will begin to issue generic top level domain names, or gTLDs, more broadly than it had previously. ICANN expects to begin to take applications for gTLDs in April or May of 2009 with an application fee of \$100,000 or more per application. ICANN expects the first of these customized gTLDs to be issued in the fourth quarter of 2009.

We are currently evaluating whether we will apply to become an ICANN-accredited registry provider with respect to one or more customized gTLDs, or create our own alternative DNS root directory to manage the assignment of non-standard secure domain names. We have not yet begun discussions with ICANN and we cannot assure you that we will be successful in obtaining ICANN accreditation for our registry service on terms acceptable to us or at all. Whether or not we obtain accreditation from ICANN, we will be subject to the ongoing risks arising out of the delegation of the U.S. government's responsibilities for the domain name system to the U.S. Department of Commerce and ICANN and the evolving government regulatory environment with respect to domain name registry services.

***The laws governing online secure communications are largely unsettled, and if we become subject to various government regulations, costs associated with those regulations may materially adversely affect our business.***

The current regulatory environment for our services remains unclear. We can give no assurance that our planned product offerings will be in compliance with local, state and/or U.S. federal laws or other laws. Further, we can give no assurance that we will not unintentionally violate such laws or that such laws will not be modified, or that new laws will be enacted in the future which would cause us to be in violation of such laws.

VoIP services are not currently subject to all of the same regulations that apply to traditional telephony. The U.S. Federal Communications Commission has imposed some traditional telephony requirements on VoIP such as disability access requirements and other obligations. It is possible that federal and state legislatures may seek to impose increased fees and administrative burdens on VoIP, data and video providers. Such regulations could result in substantial costs depending on the technical changes required to accommodate the requirements, and any increased costs could erode the pricing advantage over competing forms of communication and adversely affect consumer adoption of VoIP products generally.

The use of the Internet and private IP networks to provide voice, video and other forms of real-time, two-way communications services is a relatively recent development. Although the provisioning of such services is currently permitted by U.S. law and is largely unregulated within the United States, several foreign governments have adopted laws and/or regulations that could restrict or prohibit the provisioning of voice communications services over the Internet or private IP networks. More aggressive domestic or international regulation of the Internet in general, and Internet telephony providers and services specifically, may materially and adversely affect our business, financial condition, operating results and future prospects, particularly if increased numbers of governments impose regulations restricting the use and sale of IP telephony services.

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In addition to regulations addressing Internet telephony and broadband services, other regulatory issues relating to the Internet in general could affect our ability to provide our planned security solutions. Congress has adopted legislation that regulates certain aspects of the Internet, including online content, user privacy, taxation, liability for third-party activities and jurisdiction. In addition, a number of initiatives pending in Congress and state legislatures would prohibit or restrict advertising or sale of certain products and services on the Internet, which may have the effect of raising the cost of doing business on the Internet generally.

***Telephone carriers have petitioned governmental agencies to enforce regulatory tariffs, which, if granted, would increase the cost of online communication, and such increase in cost may impede the growth of online communication and adversely affect our business.***

The growing popularity and use of the Internet has burdened the existing telecommunications infrastructures, and many high traffic areas have begun to experience interruptions in service. As a result, certain local telephone carriers have petitioned governmental agencies to enforce regulatory tariffs on IP telephony traffic that crosses over the traditional telephone networks. If any of these petitions or the relief that they seek is granted, the costs of communicating via online could increase substantially, potentially adversely affecting the growth in the use of online secure communications. Any of these developments could have an adverse effect on our business.

***The departure of Kendall Larsen, our Chief Executive Officer and President, and/or other key personnel could compromise our ability to execute our strategic plan and may result in additional severance costs to us.***

Our success largely depends on the skills, experience and efforts of our key personnel, including Kendall Larsen, our Chief Executive Officer and President. We have no employment agreements with any of our key executives that prevent them from leaving us at any time. In addition, we do not maintain key person life insurance for any of our officers or key employees. The loss of Mr. Larsen, or our failure to retain other key personnel, would jeopardize our ability to execute our strategic plan and materially harm our business.

***We will need to recruit and retain additional qualified personnel to successfully grow our business.***

Our future success will depend in part on our ability to attract and retain qualified operations, marketing and sales personnel as well as engineers. Inability to attract and retain such personnel could adversely affect our business. Competition for engineering, sales, marketing and executive personnel is intense, particularly in the technology and Internet sectors and in the regions where our facilities are located. We can provide no assurance that we will attract or retain such personnel.

***Growth of internal operations and business may strain our financial resources.***

We intend to significantly expand the scope of our operating and financial systems in order to build our business. Our growth rate may place a significant strain on our financial resources for a number of reasons, including, but not limited to, the following:

- the need for continued development of the financial and information management systems;
- the need to manage relationships with future licensees, resellers, distributors and strategic partners;
- the need to hire and retain skilled management, technical and other personnel necessary to support and manage our business; and
- the need to train and manage our employee base.



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The addition of new infrastructure services, networks, vertical categories and affinity websites and the attention they demand, on top of the attention demanded by our pending litigation with Microsoft, may also strain our management resources. We cannot give you any assurance that we will adequately address these risks and, if we do not, our ability to successfully expand our business could be adversely affected.

***If we expand into international markets, our inexperience outside the United States would increase the risk that our international expansion efforts will not be successful, which would in turn limit our prospects for growth.***

We may explore expanding our business to outside the United States. Expansion into international markets requires significant management attention and financial resources. In addition, we may face the following risks associated with any expansion outside the United States:

- challenges caused by distance, language and cultural differences;
- legal, legislative and regulatory restrictions;
- currency exchange rate fluctuations;
- economic instability;
- longer payment cycles in some countries;
- credit risk and higher levels of payment fraud;
- potentially adverse tax consequences; and
- other higher costs associated with doing business internationally.

These risks could harm our international expansion efforts, which would in turn harm our business prospects.

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

As a public company, we will continue to incur significant legal, accounting and other expenses that VirnetX did not incur as a private company. We expect the laws, rules and regulations governing public companies to increase our legal and financial compliance costs and to make some activities more time-consuming and costly, and these costs could be material to us.

***Failing to maintain the effectiveness of our internal control over financial reporting could cause the cost related to remediation to increase and could cause our stock price to decline.***

In the future, our management may identify deficiencies regarding the design and effectiveness of our system of internal control over financial reporting that we engage in pursuant to Section 404 of the Sarbanes-Oxley Act (“Section 404”) as part of our Form 10-K. Such deficiencies could include those arising from turnover of qualified personnel or arising as a result of acquisitions, which we may not be able to remediate in time to meet the continuing reporting deadlines imposed by Section 404 and the costs of which may harm our results of operations. In addition, if we fail to maintain the adequacy of our internal controls, as such standards are modified, supplemented or amended from time to time, we may not be able to ensure that our management can conclude on an ongoing basis that we have effective internal controls. We also may not be able to retain an independent registered public accounting firm with sufficient resources to attest to and report on our internal controls in a timely manner. Moreover, our registered public accounting firm may not agree with our management’s future assessments and may deem our controls ineffective if we are unable to remediate on a timely basis. If in the future we are unable to assert that we maintain effective internal controls, our investors could lose confidence in the accuracy and completeness of our financial reports that in turn could cause our stock price to decline.

***Our ability to sell our solutions will be dependent on the quality of our technical support, and our failure to deliver high-quality technical support services could have a material adverse effect on our sales and results of operations.***

If we do not effectively assist our customers in deploying our products, succeed in helping our customers quickly resolve post-deployment issues and provide effective ongoing support, or if potential customers perceive that we may not be able to achieve the foregoing, our ability to sell our products would be adversely affected, and our reputation with potential customers could be harmed. In addition, as we expand our operations internationally, our technical support team will face additional challenges, including those associated with delivering support, training and documentation in languages other than English. As a result, our failure to deliver and maintain high-quality technical support services to our customers could result in customers choosing to use our competitors' products instead of ours in the future.

#### **Risks Related to Our Stock**

***Our business is subject to risks associated with the ongoing financial crisis and weakening global economy.***

The recent severe tightening of the credit markets, turmoil in the financial markets, and weakening global economy impacts our ability to raise needed capital and enter into customer agreements. These slowdowns are expected to worsen if these economic conditions are prolonged or deteriorate further. Further, these conditions and uncertainty about future economic conditions make it challenging for us to forecast our operating results, make business decisions, and identify the risks that may affect our business, financial condition and results of operations. If we are not able to timely and appropriately adapt to changes resulting from the difficult macroeconomic environment, our business, financial condition, and results of operations may be significantly negatively affected.

***Trading in our common stock is limited and the price of our common stock may be subject to substantial volatility, particularly in light of the instability in the financial and capital markets.***

Our common stock is listed on NYSE Amex but its daily trading volume has been limited, sporadic and volatile, particularly in light of the ongoing financial crisis. Economic uncertainty tends to exacerbate volatility in the financial markets. In the past several months, the market price of our common stock has experienced significant fluctuation. Between January 1, 2008 and December 31, 2008, the reported last sale price for our common stock has ranged from \$7.06 to \$0.89 per share. With such volatility, there can be no assurance that we will remain qualified to be listed on NYSE Amex. We expect the price of our common stock to continue to be volatile as a result of a number of factors, including, but not limited to, the following:

- developments in our pending litigation against Microsoft;
- quarterly variations in our operating results;
- large purchases or sales of common stock;
- actual or anticipated announcements of new products or services by us or competitors;
- general conditions in the markets in which we compete; and
- economic and financial conditions.

***Because ownership of our common shares is concentrated, you and other investors will have minimal influence on stockholder decisions.***

As of December 31, 2008, our officers and directors beneficially owned an aggregate of 9,385,618 shares, or 26.16% of our outstanding common stock. In addition, a group of stockholders that, as of December 31, 2007, held 4,766,666 shares, or 13.7% of our outstanding common stock, have entered into a voting agreement with us that requires them to vote all of their shares of our voting stock in favor of the director nominees approved by our Board of Directors at each director election going forward, and in a manner that is proportional to the votes cast by all other voting shares as to any other matters submitted to the stockholders for a vote. As a result, our existing officers and directors could significantly influence shareholder actions of which you disapprove or that are contrary to your interests. This ability to exercise significant influence could prevent or significantly delay another company from acquiring or merging with us.

***Large portions of our outstanding common shares were released from contractual restrictions on July 5, 2008 and December 31, 2008, and sales of those shares may drive down the price of our stock.***

Stockholders who received our common shares as a result of the merger between PASW, Inc. and VimetX entered into a lock-up agreement restricting sales of their shares until July 5, 2008. Subsequently, certain of our stockholders signed a lock-up agreement with the underwriter in connection with our public offering in December 2007, which restricted sales of their shares until December 31, 2008. Sales of these shares released from lock-up on July 5, 2008 and December 31, 2008 may have driven down the price of our stock. The 8,489,545 shares that became eligible for trading on December 31, 2008 represented 24.3% of our outstanding common stock as of December 31, 2008.

***Our protective provisions could make it difficult for a third party to successfully acquire us even if you would like to sell your shares to them.***

We have a number of protective provisions that could delay, discourage or prevent a third party from acquiring control of us without the approval of our Board of Directors. Our protective provisions include:

- **A staggered Board of Directors:** This means that only one or two directors (since we have a five-person Board of Directors) will be up for election at any given annual meeting. This has the effect of delaying the ability of stockholders to effect a change in control of us since it would take two annual meetings to effectively replace at least three directors which represents a majority of the Board of Directors.
- **Blank check preferred stock:** Our Board of Directors has the authority to establish the rights, preferences and privileges of our 10,000,000 authorized, but unissued, shares of preferred stock. Therefore, this stock may be issued at the discretion of our Board of Directors with preferences over your shares of our common stock in a manner that is materially dilutive to existing stockholders. In addition, blank check preferred stock can be used to create a “poison pill” which is designed to deter a hostile bidder from buying a controlling interest in our stock without the approval of our Board of Directors. We have not adopted such a “poison pill;” but our Board of Directors has the ability to do so in the future, very rapidly and without stockholder approval.
- **Advance notice requirements for director nominations and for new business to be brought up at stockholder meetings:** Stockholders wishing to submit director nominations or raise matters to a vote of the stockholders must provide notice to us within very specific date windows and in very specific form in order to have the matter voted on at a stockholder meeting. This has the effect of giving our Board of Directors and management more time to react to stockholder proposals generally and could also have the effect of disregarding a stockholder proposal or deferring it to a subsequent meeting to the extent such proposal is not raised properly.
- **No stockholder actions by written consent:** No stockholder or group of stockholders may take actions rapidly and without prior notice to our Board of Directors and management or to the minority stockholders. Along with the advance notice requirements described above, this provision also gives our Board of Directors and management more time to react to proposed stockholder actions.
- **Super majority requirement for stockholder amendments to the By-laws:** Stockholder proposals to alter or amend our By-laws or to adopt new By-laws can only be approved by the affirmative vote of at least 66 2/3% of the outstanding shares.
- **Elimination of the ability of stockholders to call a special meeting of the stockholders:** Only the Board of Directors or management can call special meetings of the stockholders. This could mean that stockholders, even those who represent a significant block of our shares, may need to wait for the annual meeting before nominating directors or raising other business proposals to be voted on by the stockholders.

***Securities analysts may not cover our common stock and this may have a negative impact on our common stock's market price.***

The trading market for our common stock may depend on the research and reports that securities analysts publish about us or our business. We do not have any control over these analysts. There is no guarantee that securities analysts will cover our common stock. If securities analysts do not cover our common stock, the lack of research coverage may adversely affect our common stock's market price. If we are covered by securities analysts, and our stock is downgraded, our stock price would likely decline. If one or more of these analysts ceases to cover us or fails to publish regularly reports on us, we could lose or fail to gain visibility in the financial markets, which could cause our stock price or trading volume to decline.

***We may seek to raise additional funds, finance acquisitions or develop strategic relationships by issuing capital stock that would dilute your ownership.***

We have financed our operations, and we expect to continue to finance our operations, acquisitions and develop strategic relationships, by issuing equity or convertible debt securities, which could significantly reduce the percentage ownership of our existing stockholders. Furthermore, any newly issued securities could have rights, preferences and privileges senior to those of our existing stock. Moreover, any issuances by us of equity securities may be at or below the prevailing market price of our stock and in any event may have a dilutive impact on your ownership interest, which could cause the market price of stock to decline. We may also raise additional funds through the incurrence of debt or the issuance or sale of other securities or instruments senior to our common shares. The holders of any debt securities or instruments we may issue would have rights superior to the rights of our common stockholders.

***We have no current intention of declaring or paying any cash dividends on our common stock.***

We do not plan to declare or pay any cash dividends on our common stock. Our current policy is to use all funds and any earnings in the operation and expansion of our business.

**Item 1B. Unresolved Staff Comments.**

None.

**Item 2. Properties.**

Our principal executive offices are located at 5615 Scotts Valley Drive, Suite 110, Scotts Valley, California 95066. We lease this property from a third party for a term that ends in 2012. We have no other properties and believe that our office facility is suitable and appropriately supports our current business needs.

**Item 3. Legal Proceedings.**

We believe Microsoft Corporation is infringing certain of our patents. Accordingly, we commenced a lawsuit against Microsoft on February 15, 2007 by filing a complaint in the United States District Court of the Eastern District of Texas, Tyler Division. Pursuant to the complaint, we allege that Microsoft infringes two of our U.S. patents: U.S. Patent No. 6,502,135 B1, entitled "Agile Network Protocol for Secure Communications with Assured System Availability," and U.S. Patent No. 6,839,759 B2, entitled "Method for Establishing Secure Communication Link Between Computers of Virtual Private Network Without User Entering Any Cryptographic Information." On April 5, 2007, we filed an amended complaint specifying certain accused products at issue and alleging infringement of a third, recently issued U.S. patent: U.S. Patent No. 7,188,180 B2, entitled "Method for Establishing Secure Communication Link Between Computers of Virtual Private Network." We are seeking both damages, in an amount subject to proof at trial, and injunctive relief. Microsoft answered the amended complaint and asserted counterclaims against us on May 4, 2007. Microsoft counterclaimed for declarations that the three patents are not infringed, are invalid and are unenforceable. Microsoft seeks an award of its attorneys' fees and costs. We filed a reply to Microsoft's counterclaims on May 24, 2007. We have served our infringement contentions directed to certain of Microsoft's operating system and unified messaging and collaboration applications. On March 31, 2008, Microsoft filed a Motion to Dismiss for lack of standing, which was denied by the court pursuant to an order dated June 3, 2008. Also pursuant to that court decision, on June 10, 2008, SAIC joined us in our lawsuit as a plaintiff. On November 19, 2008, the court granted our motion to amend our infringement contentions, permitting us to provide increased specificity and citations to Microsoft's proprietary documents and source code to support our infringement case against Microsoft's accused products, including, among other things, Windows XP, Vista, Server 2003, Server 2008, Live Communication Server, Office Communication Server and Office Communicator. Microsoft was ordered to provide further information regarding its non-infringement contentions and invalidity contentions in light of the amended infringement contentions. Microsoft was also ordered to provide additional e-mail discovery to us. Microsoft was not required to search disaster recovery tapes for additional information. Discovery has begun, a Markman hearing on claim construction was conducted on February 17, 2009, and the parties are currently awaiting the Court's order with respect to the hearing. The trial is scheduled to begin on October 12, 2009.

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*Notwithstanding anything to the contrary set forth in any of the Company's filings under the Securities Act of 1933 or the Securities Exchange Act of 1934 that might incorporate future filings, the information set forth on the Public Access to Court Electronic Records, or PACER, website shall not be deemed to be a part of or incorporated by reference into any such filings. The Company does not warrant the accuracy or completeness of the PACER website, or the adequacy of the PACER website and expressly disclaims liability for errors or omissions on such website.*

Because we have determined that Microsoft's alleged unauthorized use of our patents would cause us severe economic harm and the failure to cause Microsoft to discontinue its use of such patents could result in the termination of our business, we have dedicated a significant portion of our economic resources, to date, to the prosecution of the Microsoft litigation and expect to continue to do so for the foreseeable future.

Although we believe Microsoft infringes three of our patents and we intend to vigorously prosecute this case, at this stage of the litigation the outcome cannot be predicted with any degree of reasonable certainty. Additionally, the Microsoft litigation will be costly and time-consuming, and we can provide no assurance that we will obtain a judgment against Microsoft for damages and/or injunctive relief. Should the District Court issue a judgment in favor of Microsoft, and in connection with such judgment determine that we had acted in bad faith or with fraudulent intent, or we were otherwise found to have exhibited inequitable conduct, the Court could award attorney fees to Microsoft, which would be payable by us.

In the near term, we will dedicate significant time and resources to the Microsoft litigation. The risks associated with such dedication of time and resources are set forth in the "Risk Factors" section of this Annual Report on Form 10-K.

One or more potential intellectual property infringement claims may also be available to us against certain other companies who have the resources to defend against any such claims. Although we believe these potential claims are worth pursuing, commencing a lawsuit can be expensive and time-consuming, and there is no assurance that we will prevail on such potential claims. In addition, bringing a lawsuit may lead to potential counterclaims which may preclude our ability to commercialize our initial products, which are currently in development.

Currently, we are not a party to any other pending legal proceedings, and are not aware of any proceeding threatened or contemplated against us by any governmental authority or other party.

#### **Item 4. *Submission of Matters to a Vote of Security Holders.***

No matters were submitted to our security holders during the fourth quarter of the fiscal year covered by this Annual Report.

**PART II****Item 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.****Market Information**

Our common stock currently trades under the symbol "VHC" on NYSE Amex. Before the New York Stock Exchange acquired the American Stock Exchange in 2008, our common stock had traded under the "VHC" symbol on the American Stock Exchange since December 26, 2007. Before then, our common stock traded in the over-the-counter market on the Nasdaq OTC Bulletin Board under the symbols "VNXH," and "PASW." Our common stock warrants issued in our public offering that closed on January 30, 2009, trade as of March 13, 2009 under the symbols VHCOW, VHCOZ and VHCOL on the OTC Bulletin Board.

The following table shows the price range of our common stock, as reported on the OTC Bulletin Board the American Stock Exchange or NYSE Amex, as applicable, for each quarter ended during the last two fiscal years and the subsequent interim periods for which financial statements are included in this Annual Report.

<b>Quarter Ended</b>	<b>High</b>	<b>Low</b>
3/31/07	\$ 5.97	\$ 0.63
6/30/07	\$ 5.10	\$ 3.33
9/30/07	\$ 5.10	\$ 3.96
12/31/07	\$ 6.75	\$ 4.08
3/31/08	\$ 6.95	\$ 4.26
6/30/08	\$ 7.06	\$ 3.50
9/30/08	\$ 4.07	\$ 1.26
12/31/08	\$ 2.98	\$ 0.89

The closing price of our common stock on NYSE Amex on March 26, 2009 was \$1.18 per share.

**Holders**

As of March 26, 2009, we had 67 stockholders of record.

**Dividends**

We have not paid any cash dividends on our common stock, and do not anticipate paying cash dividends in the foreseeable future. Our current policy is to retain earnings, if any, to fund operations, and the development and growth of our business. Any future determination to pay cash dividends will be at the discretion of our Board of Directors and will be dependent upon our financial condition, operation results, capital requirements, applicable contractual restrictions, restrictions in our organizational documents, and any other factors that our Board of Directors deems relevant.

**Securities Authorized for Issuance Under Equity Compensation Plans**

On April 17, 1998, when we operated under the name PASW, Inc., we adopted an equity incentive program. Under this program, we may grant incentive stock options, non-statutory stock options, stock appreciation rights, stock bonuses and rights to acquire restricted stock to employees, directors and consultants (except for incentive stock options which may only be granted to employees). The number of shares of common stock initially reserved for issuance under this program was 150,580 shares post-split. As of December 31, 2008, there were no outstanding options or rights under this program and we don't intend to grant any equity incentives in the future under this plan.

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In connection with the merger between VimetX Holding Corporation and VimetX, our Board of Directors approved our adoption of the VimetX 2005 Stock Plan, as amended, to cover grants of stock options and restricted stock units to our employees and consultants. Our Board of Directors renamed this stock plan the VimetX 2007 Stock Plan. The total number of shares of our common stock reserved for issuance under the VimetX 2007 Stock Plan is 11,624,469, of which as of December 31, 2008, there were 2,651,392 shares remaining available for future grants. Our stockholders approved the VimetX 2007 Stock Plan at our 2008 annual stockholders' meeting.

<b>Plan Category</b>	<b>Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights</b> <b>(a)</b>	<b>Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights</b> <b>(b)</b>	<b>Number of Securities Remaining Available for Compensation Plans Excluding Securities Reflected in Column (a)</b> <b>(c)</b>
<b>Equity compensation plans approved by security holders</b>	4,468,595	2.98	2,651,392
<b>Equity compensation plans not approved by security holders</b>	—	—	—
<b>Total</b>	4,468,595	2.98	2,651,392

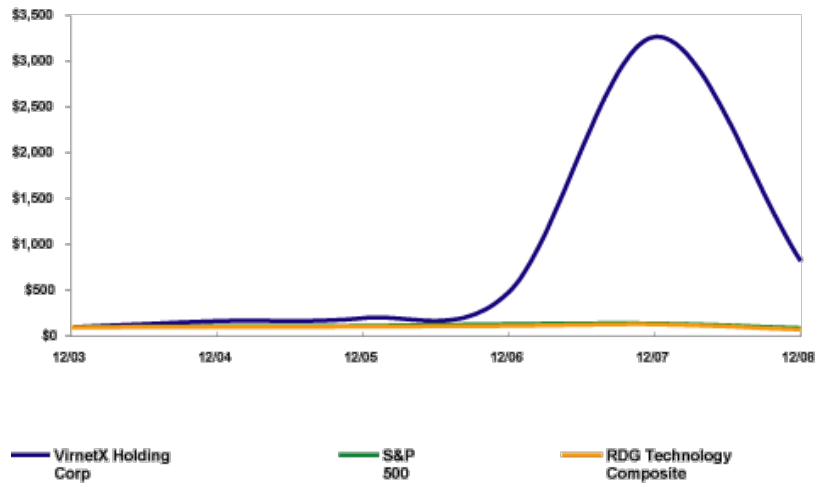
**Recent Sales of Unregistered Securities**

Not applicable.

**Performance Graph**

**COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN\***

Among VirnetX Holding Corporation, The S&P 500 Index and The RDG Technology Composite Index



\*\$100 invested on 12/31/03 in stock or index, including reinvestment of dividends. Fiscal year ending December 31.

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*The stock price performance reflected on this graph is not necessarily indicative of future stock price performance.*

	<u>12/03</u>	<u>12/04</u>	<u>12/05</u>	<u>12/06</u>	<u>12/07</u>	<u>12/08</u>
<b>VirnetX Holding Corporation</b>	\$ 100.00	\$ 166.67	\$ 200.00	\$ 483.33	\$3,266.67	\$ 822.22
<b>S&amp;P 500</b>	100.00	110.88	116.33	134.70	142.10	89.53
<b>RDG Technology Composite</b>	100.00	104.00	106.32	115.98	132.44	75.01



[Table of Contents](#)**Item 6. Selected Financial Data.**

You should read the selected consolidated financial data set forth below in conjunction with our consolidated financial statements, the notes to our consolidated financial statements and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” contained elsewhere in this Annual Report on Form 10-K. Our historical results are not necessarily indicative of results to be expected for future periods.

	<b>For the Year Ended December 31, 2008</b>	<b>For the Year Ended December 31, 2007</b>	<b>For the Year Ended December 31, 2006</b>	<b>Period from August 5, 2005 (Date of Inception) to December 31, 2005</b>
<b>Consolidated Statement of Operations Data:</b>				
Revenue	\$ 133,744	\$ 74,866	\$ 0	\$ 0
Operating expenses	12,355,332	8,725,210	1,407,675	882,478
Net loss	(12,072,180)	(8,692,164)	(1,401,339)	(882,478)
Loss per share	\$ (.35)	\$ (.36)	(.08)	\$ (.06)
<b>Consolidated Balance Sheet Data:</b>				
Cash and cash equivalents	\$ 457,155	\$ 8,589,447	\$ 139,997	\$ 86,552
Total assets	978,982	9,279,166	195,123	147,722
Long-term obligation	160,000	204,000	0	0
Stockholders’ equity (deficit)	\$ (894,351)	\$ 8,495,376	\$ 107,737	\$ (82,278)

**Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

*This Annual Report on Form 10-K, including this Management's Discussion and Analysis of Financial Condition and Results of Operations contains "forward-looking" statements within the meaning of the Private Securities Litigation Reform Act of 1995, which provides a "safe harbor" for statements about future events, products and future financial performance that are based on the beliefs of, estimates made by and information currently available to our management. Except for the historical information contained herein, the outcome of the events described in these forward-looking statements is subject to risks and uncertainties. See "Risk Factors" for a discussion of these risks and uncertainties. The following discussion should be read in conjunction with and is qualified in its entirety by reference to our consolidated financial statements and accompanying notes included elsewhere in this Annual Report on Form 10-K. Actual results and the outcome or timing of certain events may differ significantly from those stated or implied by these forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in Item 1A of Part I "Risk Factors" and other factors from time to time described in our other filings with the Securities and Exchange Commission, or SEC. For this purpose, using the terms "believe," "expect," "expectation," "anticipate," "can," "should," "would," "could," "estimate," "appear," "based on," "may," "intended," "potential," "indicate," "are emerging" and "possible" or similar statements are forward-looking statements that involve risks and uncertainties that could cause our actual results and the outcome and timing of certain events to differ materially from those stated or implied by these forward-looking statements. By making forward-looking statements, we have not assumed any obligation to, and you should not expect us to, update or revise those statements because of new information, future events or otherwise.*

*As used herein, "we," "us," "our," or the "Company" means VirnetX Holding Corporation and its wholly-owned subsidiaries, including VirnetX, collectively, on a consolidated basis.*

**Company Overview**

We are a development stage company focused on commercializing a patent portfolio for securing real-time communications over the Internet. These patents were acquired by our principal operating subsidiary, VirnetX, from Science Applications International Corporation, or SAIC. SAIC is a FORTUNE 500® scientific, engineering, and technology applications company that uses its deep domain knowledge to solve problems of vital importance to the nation and the world, in national security, energy and the environment, critical infrastructure, and health.

In January 2009, we closed a public offering of 2,470,000 shares of our common stock, including 270,000 of which were issued pursuant to the underwriter's over-allotment option, plus warrants to purchase 1,235,000 shares of common stock at \$2.00 per share, including 135,000 of which were issued pursuant to the underwriter's over-allotment option, warrants to purchase 1,235,000 shares of common stock at \$3.00 per share, including 135,000 of which were issued pursuant to the underwriter's over-allotment option, and warrants to purchase 1,235,000 shares of common stock at \$4.00 per share, including 135,000 of which were issued pursuant to the underwriter's over-allotment option. The offering at \$1.50 per unit raised gross proceeds of approximately \$3,700,000 before deducting the underwriter's fees and other costs of the offering. The net cash raised was approximately \$3,300,000.

In December 2007, we closed an underwritten public offering of 3.45 million shares of our common stock, raising gross proceeds of \$13.8 million before underwriting discounts and commissions and offering expenses. In connection with the 2007 offering, our common shares began trading on the American Stock Exchange under the ticker symbol "VHC." Our principal business activities to date are our efforts to commercialize our patent portfolio. We also conduct the remaining activities of PASW, Inc., which are generally limited to the collection of royalties on certain Internet-based communications by a wholly-owned Japanese subsidiary of ours pursuant to the terms of a single license agreement. The revenue generated by this agreement is not significant.

Although we believe we may derive revenues in the future from our principal patent portfolio and are currently endeavoring to develop certain of those patents into marketable products, we have not done so to date. Because we have limited capital resources, our revenues are insignificant and our expenses, including but not limited to those we expect to incur in our patent infringement case against Microsoft, are substantial, we may be unable to successfully complete our business plans, our business may fail and your investment in our securities may become worthless. See "Risk Factors" for additional information.

We are in the development stage and consequently we are subject to the risks associated with development stage companies including: the need for additional financings; the uncertainty that our patent and technology licensing program development efforts will produce revenue bearing licenses for us; the uncertainty that our development initiatives will produce successful commercial products as well as the marketing and customer acceptance of such products; competition from larger organizations; dependence on key personnel; uncertain patent protection; and dependence on corporate partners and collaborators. To achieve successful operations, we will require additional capital to continue research and development and marketing efforts. No assurance can be given as to the timing or ultimate success of obtaining future funding.

### **Recent Developments**

We announced our GABRIEL Connection Technology™ on April 1, 2008. Our GABRIEL Connection Technology™ is designed to secure all types of real-time communications over the Internet. This technology uses industry standard encryption methods with our patented DNS lookup mechanisms to create a secure communication link between users intending to communicate in real time over the Internet. This technology automatically encrypts data allowing organizations and individuals to establish communities of secure, registered users to transmit information between multiple devices and operating systems. These secure network communities, which we call secure private domains, or SPDs, are designed to be fully-customizable and support applications such as IM, VoIP, mobile services, streaming video, file transfer and remote desktop in a completely secure environment.

On May 14, 2008, we announced jointly with ipCapital Group the completion and results of ipCapital Group's evaluation of our business model, product, patent portfolio, technology and software. The goal of the evaluation was to determine the potential commercialization value range to potential licensing partners in IP telephony, mobility, fixed-mobile convergence and unified communications markets. Based on ipCapital Group's proprietary ipValue Model, the estimated potential commercialization value range of our business model, product, patent portfolio, technology and software indicates a significant market opportunity. We are currently in discussions with prospective customers in our target markets.

On March 31, 2008, Microsoft filed a motion to dismiss our patent infringement case against it. On June 3, 2008, the court denied Microsoft's motion to dismiss. The court ruled that VimetX has "constitutional standing" to sue for patent infringement. Also pursuant to the court decision, on June 10, 2008, SAIC joined us in our lawsuit as a plaintiff.

On August 26, 2008, we were awarded U.S. patent number 7,418,504 by the U.S. Patent and Trademark Office. The new patent, titled "Agile network protocol for secure communications using secure domain names" describes a system for establishing a secure communication link using secure domain names. In conjunction with the issuance of this patent, we will seek to commercialize these exclusive rights in the United States by establishing the secure domain name registry service for the Internet. Additional information about the patent can be found on [www.uspto.gov](http://www.uspto.gov).

On October 23, 2008, our Board of Directors authorized the establishment of an advisory board and we concurrently entered into advisory board agreements with John Cronin, Paul Henderson, and John F. Slitz. The members of our advisory board collaborate with and provide advice and assistance to us, with a focus on facilitating the development and commercialization of our licensing program. We will strategically select members of our advisory board, including those appointed on October 23, 2008, who are well-informed and well-connected in fields relevant to our software and technology solutions, market direction, and future plans. Additional biographical information regarding the advisors appointed on October 23, 2008 is included under the section of this Annual Report incorporated by reference into our 2009 proxy entitled "Management."

On November 19, 2008, the court granted our motion to amend our infringement contentions, permitting us to provide increased specificity and citations to Microsoft's proprietary documents and source code to support our infringement case against Microsoft's accused products, including, among other things, Windows XP, Vista, Server 2003, Server 2008, Live Communication Server, Office Communication Server and Office Communicator. Microsoft was ordered to provide further information regarding its non-infringement contentions and invalidity contentions in light of the amended infringement contentions. Microsoft was also ordered to provide additional e-mail discovery to us. Microsoft was not required to search disaster recovery tapes for additional information.

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On January 30, 2009, we closed the public offering of 2,470,000 shares of our common stock at \$1.50 per share. As further described in the prospectus for the offering filed on SEC's EDGAR filing website, [www.sec.gov](http://www.sec.gov), for each share purchased in the offering, an investor received registered warrants to purchase 0.5 shares of our common stock at \$2.00 per share, 0.5 shares of our common stock at \$3.00 per share and 0.5 shares of our common stock at \$4.00 per share.

On February 10, 2009, VimetX, Inc., our wholly-owned subsidiary, was awarded U.S. patent number 7,490,151 by the United States Patent and Trademark Office. The new patent, titled "Establishment of a secure communication link based on a domain name service (DNS) request" describes a secure mechanism for communication over the Internet. In conjunction with the issuance of this patent, we will seek to commercialize these exclusive rights in the United States by establishing the secure domain name registry service for the Internet. Additional information about the patent can be found on [www.uspto.gov](http://www.uspto.gov).

On February 19, 2009, the Markman hearing on claim construction was conducted in connection with the Microsoft litigation and the parties are currently awaiting the Court's order with respect to the hearing.

On March 13, 2009, the common stock warrants issued in connection with our public offering that closed on January 30, 2009 were approved for listing on the OTC Bulletin Board under the symbols VHCOW, VHCOZ and VHCOL.

### **Critical Accounting Policies**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires us 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 reported period. The critical accounting policies we employ in the preparation of our consolidated financial statements are those which involve impairment of long-lived assets, income taxes, fair value of financial instruments and stock-based compensation.

#### ***Impairment of Long-Lived Assets***

We identify and record impairment losses on long-lived assets used in operations when events and changes in circumstances indicate that the carrying amount of an asset might not be recoverable, but not less than annually. Recoverability is measured by comparison of the anticipated future net undiscounted cash flows to the related assets' carrying value. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the projected discounted future net cash flows arising from the asset.

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

We account for income taxes under the liability method. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to affect taxable income. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts expected to be realized.

#### ***Fair Value of Financial Instruments***

Carrying amounts of our financial instruments, including cash and cash equivalents, accounts payable, and accrued liabilities, approximate their fair values due to their short maturities.

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

We account for share-based compensation in accordance with Statement of Financial Accounting Standards, or SFAS, No. 123 (revised 2004), "*Share-Based Payment*," or SFAS 123(R), which requires the measurement and recognition of compensation expense in the statement of operations for all share-based payment awards made to employees and directors including employee stock options based on estimated fair values. Using the modified retrospective transition method of adopting SFAS 123(R), the financial statements presented herein reflect compensation expense for stock-based awards as if the provisions of SFAS 123(R) had been applied from the date of our inception.

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In addition, as required by Emerging Issues Task Force Consensus No. 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling Goods or Services, we record stock and options granted to non-employees at fair value of the consideration received or the fair value of the equity investments issued as they vest over the performance period.

### **Recent Accounting Pronouncements**

In March 2008, the FASB issued SFAS No. 161, “*Disclosures about Derivative Instruments and Hedging Activities*”, an amendment of FASB Statement No. 133, or SFAS No. 161. SFAS No. 161 requires enhanced disclosures about an entity’s derivative and hedging activities. These enhanced disclosures will discuss (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity’s financial position, financial performance, and cash flows. SFAS No. 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. We have not determined the impact, if any SFAS No. 161 will have on our consolidated financial statements.

In December 2007, the FASB ratified EITF No. 07-1, “*Accounting for Collaborative Agreements*.” This standard provides guidance regarding financial statement presentation and disclosure of collaborative agreements, as defined, which includes arrangements regarding the developing and commercialization of products and product candidates. EITF 07-01 is effective as of January 1, 2009. Implementation of this standard is not expected to have a material impact on our consolidated statements of operations or financial position.

In June 2007, the FASB ratified EITF 07-3, “*Accounting for Nonrefundable Advance Payments for Goods or Services to be used in Future Research and Development Activities*.” This standard requires that nonrefundable advance payments for goods and services that will be used or rendered in future research and development activities pursuant to executory contractual arrangements be deferred and recognized as an expense in the period the related goods are delivered or services are performed. EITF No. 07-3 became effective as of January 1, 2008 and it did not have a material impact on our consolidated statements of operations or financial position upon adoption.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, or SFAS No. 157, “*Fair Value Measurements*.” SFAS No. 157 provides guidance for using fair value to measure assets and liabilities. It also responds to investors’ request for expanded information about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair valued measurements on earnings. SFAS No. 157 applies whenever standards require (or permit) assets or liabilities to be measured at fair value, and does not expand the use of fair value in any new circumstances. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years, with early adoption permitted, except for the impact of FASB Staff Position, or FSP, 157-2. FSP 157-2 deferred the adoption of SFAS 157 for non financial assets and liabilities until years ended after November 15, 2008. Adoption of these SFAS No. 157 requirements did not have a material impact on our consolidated statement of operations or financial position.

### **Operations**

#### ***Revenue — Royalties***

Revenue generated for the twelve months ended December 31, 2008 was \$133,744 compared to \$74,866 during the period from July 5, 2007 (the closing date of the merger between us and VimetX, Inc.) to December 31, 2008. Our revenue in 2008 was solely limited to the royalties earned under a single license agreement through our Japanese subsidiary. We expect the revenue from this license to decrease substantially in the future. We do not intend to enter into additional licenses or generate significant revenue through our Japanese subsidiary.

### ***Research and Development Expenses***

Research and development costs include expenses paid to outside development consultants and compensation-related expenses for our engineering staff. Research and development costs are expensed as incurred.

Our research and development expenses increased from \$56,000 for the period from August 2, 2005 (date of inception) to December 31, 2005, to \$554,187 for 2006 to \$684,316 for 2007 and to \$845,324 for 2008, primarily as a result of increased engineering activities for product development. We expect research and development expenses to increase as employees are hired to provide in-house research and development. While we expect to use outside contractors for additional product development on a limited basis, we expect those costs to remain level or decline.

### ***General and Administrative Expenses***

General and administrative expenses include management and administrative personnel costs, as well as costs of outside legal, accounting, and consulting services.

Our general and administrative expenses increased from \$826,478 for the period from August 2, 2005 (date of inception) to December 31, 2005, to \$853,488 for 2006 to \$8,040,894 for 2007 and to \$11,510,008 for 2008.

Within general and administrative expenses, professional fees, primarily legal fees, increased from \$12,481 in the period from August 2, 2005 (date of inception) to December 31, 2005 to \$133,199 in 2006 to \$5,286,525 in 2007 and to \$5,798,534 in 2008. The fees were incurred to pursue the litigation with Microsoft, assist in the merger between VimetX, Inc. and VimetX Holding Corporation, audit the financial statements, assist in obtaining financing and potential contract negotiations and in general corporate matters. Legal fees may continue to increase as our patent infringement litigation moves forward and we incur the costs associated with being an SEC reporting company.

Also within general and administrative, compensation expenses increased from \$799,920 in the period from August 2, 2005 (date of inception) to December 31, 2005, to \$613,757 in 2006, \$2,152,000 in 2007 and \$2,682,431 in 2008. Compensation expenses were higher in 2005 compared to 2006 due to the higher proportion of stock based compensation expense in 2005. The increase from 2006 to 2007 in compensation expenses is due principally to stock-based compensation expense related to stock options granted to our employees and directors and an increase in the number of our employees as we added resources to comply with reporting requirements.

Other general and administrative expenses increased from \$14,077 in the period from August 2, 2005 (date of inception) to December 31, 2005 to \$106,532 in 2006 to \$602,639 in 2007 and to \$3,029,043 in 2008 as we incurred costs related to building our infrastructure and litigation support. We also incurred additional general and administrative expenses in connection with the implementation of a directors and officers' insurance policy and certain legal and transaction costs associated with the negotiation, filing and closing of our public offering on Form S-1, which we closed on January 30, 2009.

### ***Liquidity and Capital Resources***

We are in the development stage and have raised capital since our inception through the issuance of our equity securities. As of December 31, 2008, we had approximately \$457,000 in cash. Our January 2009 common stock offering raised net proceeds to us of approximately \$3,300,000. We expect to finance future cash needs primarily through proceeds from equity or debt financings, loans, and/or collaborative agreements with corporate partners. We have used the net proceeds from the sale of common and preferred stock for general corporate purposes, which have included funding research and development, litigation efforts and working capital needs.

We anticipate that our existing cash and cash equivalents are insufficient to fund our operations for longer than through the end of our second quarter of 2009. In order to obtain additional capital, we expect to evaluate alternative financing sources, including, but not limited to, the issuance of equity or debt securities, corporate alliances, joint ventures and licensing agreements; however, there can be no assurance that funding will be available on favorable terms, if at all. We cannot assure you that we will successfully commercialize our products and services or that our products and services will gain sufficient market acceptance to enable us to earn a profit. If we are unable to obtain additional capital or generate sufficient revenue from such efforts, we may be required to cease operations or to reduce cash used in our business, including the termination of commercialization efforts that may appear to be promising, the sale of our patent portfolio or other assets, the abandonment of our litigation with Microsoft or others and the reduction in overall operating activities.

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During 2008, our cash flow used in operations was approximately \$8,064,000 or an average of approximately \$672,000 per month. During the fourth quarter of 2008, our cash balance declined to an average of \$601,000 per month. We believe that our 2009 average monthly cash requirement to fund our business is unlikely to change materially from these 2008 fourth quarter figures for the first half of 2009. As a result, we anticipate that our cash balance at December 31, 2008, as supplemented by our completed common equity and warrants offering in January 2009 which raised approximately \$3,300,000 of net proceeds, will be insufficient to fund our operations for longer than through the end of our second half of 2009. We anticipate that our monthly cash requirements will increase for the second half of 2009 as we increase our expenditures for:

- our lawsuit against Microsoft;
- infrastructure;
- sales and marketing;
- research and development;
- personnel; and
- general business enhancements.

We may exceed those projected amounts if we increase these expenditures in response to business conditions we do not currently expect or for other reasons. The process of developing new security solutions is inherently complex, time-consuming, expensive and uncertain. We must make long-term investments and commit significant resources before knowing whether our patented technology offerings will achieve market acceptance. We are unable to predict when we will begin to generate material net cash inflows from our patent and technology licensing program and our secure domain name registry service.

### **Off-Balance Sheet Arrangements**

As of December 31, 2008, we did not have any off-balance sheet arrangements except for operating lease commitments and the contingent portion of our royalty obligation under our royalty agreement with SAIC as discussed in the notes to the financial statements.

### **Item 7A. *Quantitative and Qualitative Disclosures About Market Risk.***

Not applicable.

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**Item 8. Financial Statements and Supplementary Data.**

**FINANCIAL STATEMENTS**

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Board of Directors and Shareholders  
VimmetX Holding Corporation

We have audited the accompanying consolidated balance sheets of VimmetX Holding Corporation (the "Company"; a development stage enterprise) as of December 31, 2008 and 2007, and the related consolidated statements of operations, stockholders' equity (deficit) and their cash flows for the years ended December 31, 2008 and 2007 and the period from August 2, 2005 (date of inception) to December 31, 2008. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of VimmetX Holding Corporation, Inc. as of December 31, 2008 and 2007, and the consolidated results of their operations and cash flows for the years then ended and the period from August 2, 2005 (date of inception) to December 31, 2008 in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming the Company will continue as a going concern. As discussed in the notes to the Consolidated Financial Statements, the Company has not been able to generate significant revenues and has a working capital deficiency of approximately \$1,065,000 at December 31, 2008. These conditions raise substantial doubt about the Company's ability to continue as a going concern without raising additional equity, debt or other financing to fund operations. Management's plans in regard to these matters are described in the notes to the Consolidated Financial Statements. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ Farber Hass Hurley LLP

Granada Hills, California  
March 31, 2009

**VirnetX Holding Corporation**  
**(a development stage enterprise)**

**CONSOLIDATED BALANCE SHEETS**

	As of December 31, 2008	As of December 31, 2007
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 457,155	\$ 8,589,447
Accounts receivable	1,154	5,860
Prepaid expenses and other current assets	189,847	399,201
Total current assets	648,156	8,994,508
Property and equipment, net	32,565	32,658
Intangible and other assets	204,000	252,000
Deferred offering costs	94,261	—
Total assets	<u>\$ 978,982</u>	<u>\$ 9,279,166</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)</b>		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 1,669,333	\$ 531,790
Current portion of long-term obligation	44,000	48,000
Total current liabilities	1,713,333	579,790
Long-term obligation, net of current portion	160,000	204,000
Commitments and contingencies:	—	—
Stockholders' equity (deficit):		
Preferred stock, par value \$0.0001 per share		
Authorized: 10,000,000 shares at December 31, 2008 and December 31, 2007, respectively		
Issued and outstanding: 0 shares at December 31, 2008 and December 31, 2007, respectively		
Common stock, par value \$0.0001 per share		
Authorized: 100,000,000 shares at December 31, 2008 and December 31, 2007, respectively		
Issued and outstanding: 34,899,985 shares and 34,667,214 shares, at December 31, 2008 and December 31, 2007, respectively	3,489	3,467
Additional paid-in capital	22,150,321	19,467,890
Deficit accumulated during the development stage	(23,048,161)	(10,975,981)
Total stockholders' equity (deficit)	(894,351)	8,495,376
Total liabilities and stockholders' equity (deficit)	<u>\$ 978,982</u>	<u>\$ 9,279,166</u>

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

**VirnetX Holding Corporation**  
**(a development stage enterprise)**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

	<b>Year Ended December 31, 2008</b>	<b>Year Ended December 31, 2007</b>	<b>Cumulative from August 2, 2005 (Date of Inception) to December 31, 2008</b>
Revenue — Royalties	\$ 133,744	\$ 74,866	\$ 208,610
Operating expenses:			
Research and development	845,324	684,316	2,139,827
General and administrative	11,510,008	8,040,894	21,230,868
Total operating expenses	12,355,332	8,725,210	23,370,695
Loss from operations	(12,221,588)	(8,650,344)	(23,162,085)
Interest and other income (expense), net	149,408	(41,820)	113,924
Net loss	\$ (12,072,180)	\$ (8,692,164)	\$ (23,048,161)
Basic and diluted loss per share	\$ (.35)	\$ (.36)	
Weighted average shares outstanding	34,875,471	24,312,287	

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

**VirnetX Holding Corporation**  
(a development stage enterprise)

**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)**

	Series A Preferred Stock		Common Stock		Additional Paid-in Capital	Due from Stock- holder	Deficit Accumulated During Development Stage	Total Stockholders' Equity (Deficit)
	Shares	Amount	Shares	Amount				
<b>Balance at inception (August 2, 2005)</b>	—	—	—	—	—	—	—	—
Common stock issued to founders	—	—	13,285,107	1,329	(1,129)	—	—	200
Proceeds from issuance of restricted stock units to employees at \$0.0001 per share in October 2005	—	—	3,321,277	332	(252)	—	—	80
Stock-based compensation from restricted stock units	—	—	—	—	799,920	—	—	799,920
Net loss	—	—	—	—	—	—	(882,478)	(882,478)
<b>Balance at December 31, 2005</b>	—	—	<b>16,606,384</b>	<b>1,661</b>	<b>798,539</b>	<b>0</b>	<b>(882,478)</b>	<b>(82,278)</b>
Proceeds from issuance of preferred stock at \$1.00 per share in February 2006, net of issuance cost of \$26,375	1,404,000	1,377,625	—	—	—	—	—	1,377,625
Proceeds from issuance of restricted stock units to employees at \$0.01 per share in March and October 2006	—	—	975,625	97	1,953	(150)	—	1,900
Stock-based compensation: restricted stock units	—	—	—	—	130,210	—	—	130,210
Stock-based compensation: employee stock options	—	—	—	—	81,619	—	—	81,619
Net loss	—	—	—	—	—	—	(1,401,339)	(1,401,339)
<b>Balance at December 31, 2006</b>	<b>1,404,000</b>	<b>1,377,625</b>	<b>17,582,009</b>	<b>1,758</b>	<b>1,012,321</b>	<b>(150)</b>	<b>(2,283,817)</b>	<b>107,737</b>
Proceeds from exercise of options	—	—	124,548	12	29,988	—	—	30,000
Shares issued for merger	—	—	1,665,800	167	—	—	—	167
Debt converted to stock, net	—	—	2,016,016	202	1,499,648	150	—	1,500,000
Stock issued for cash at \$.75 per share, net	—	—	4,000,000	400	2,953,249	—	—	2,953,649
Stock issued for cash at \$4.00 per share, net	—	—	3,450,000	345	11,776,773	—	—	11,777,118
Stock-based compensation	—	—	—	—	818,869	—	—	818,869
Preferred stock converted to common stock	(1,404,000)	(1,377,625)	5,828,841	583	1,377,042	—	—	—
Net loss	—	—	—	—	—	—	(8,692,164)	(8,692,164)
<b>Balance at December 31, 2007</b>	—	—	<b>34,667,214</b>	<b>3,467</b>	<b>19,467,890</b>	—	<b>(10,975,981)</b>	<b>8,495,376</b>
Cashless exercise of warrants	—	—	232,771	22	—	—	—	22
Stock-based compensation	—	—	—	—	2,682,431	—	—	2,682,431
Net loss	—	—	—	—	—	—	(12,072,180)	(12,072,180)
<b>Balance at December 31, 2008</b>	—	—	<b>34,899,985</b>	<b>\$ 3,489</b>	<b>\$22,150,321</b>	—	<b>\$ (23,048,161)</b>	<b>\$ (894,351)</b>

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

**VirnetX Holding Corporation**  
(a development stage enterprise)

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Year Ended December 31, 2008	Year Ended December 31, 2007	Cumulative Period from August 2, 2005 (Date of Inception) to December 31, 2008
<b>Cash flows from operating activities:</b>			
Net loss	\$ (12,072,180)	\$ (8,692,164)	\$ (23,048,161)
<b>Adjustments to reconcile net loss to net cash used in operating activities:</b>			
Stock-based compensation	2,682,431	818,869	4,513,049
Depreciation and amortization	68,623	18,609	94,921
<b>Changes in assets and liabilities:</b>			
Prepaid expenses and other assets	119,799	(392,256)	(300,496)
Accounts payable and accrued liabilities	1,137,751	444,404	1,669,541
<b>Net cash used in operating activities</b>	<b>(8,063,576)</b>	<b>(7,802,538)</b>	<b>(17,071,146)</b>
<b>Cash flows from investing activities:</b>			
Purchase of property and equipment	(20,716)	(22,955)	(78,447)
Cash acquired in acquisition	—	14,009	14,009
<b>Net cash used in investing activities</b>	<b>(20,716)</b>	<b>(8,946)</b>	<b>(64,438)</b>
<b>Cash flows from financing activities:</b>			
Issuance of notes payable	—	250,000	250,000
Repayment of notes payable	—	(250,000)	(250,000)
Proceeds from issuance of preferred stock, net of issuance costs	—	—	1,147,625
Proceeds from issuance of restricted stock units	—	—	2,180
Proceeds from advance from preferred stockholders	—	—	230,000
Proceeds from exercise of options	—	30,000	30,000
Proceeds from convertible debt	—	1,500,000	1,500,000
Payment of royalty obligation less imputed interest	(48,000)	—	(48,000)
Proceeds from sale of common stock	—	14,730,934	14,730,934
<b>Net cash provided by (used in) financing activities</b>	<b>(48,000)</b>	<b>16,260,934</b>	<b>17,592,739</b>
<b>Net increase in cash and cash equivalents</b>	<b>(8,132,292)</b>	<b>8,449,450</b>	<b>457,155</b>
Cash and cash equivalents, beginning of period	8,589,447	139,997	—
<b>Cash and cash equivalents, end of period</b>	<b>\$ 457,155</b>	<b>\$ 8,589,447</b>	<b>\$ 457,155</b>
<b>Supplemental disclosure of cash flow information:</b>			
Cash paid during the year for taxes	\$ 9,201	\$ 800	\$ 10,801
Cash paid during the year for interest	\$ 5,622	\$ 41,630	\$ 47,252
<b>Supplemental disclosure of noncash investing and financing activities:</b>			
Conversion of advance into preferred stock	\$ —	\$ —	\$ 230,000
Royalty obligation assumed to obtain intangible assets	\$ —	\$ 252,000	\$ 252,000

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

**VirnetX Holding Corporation**  
**(a development stage enterprise)**

**NOTES TO FINANCIAL STATEMENTS**

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**Note 1 Formation and Business of the Company**

VirnetX Holding Corporation (“we,” “us,” “our” or the “Company”) are a development stage company focused on commercializing a patent portfolio for providing solutions for secure real-time communications such as instant messaging, or “IM,” and voice over internet protocol, or “VoIP.”

In July 2007 we effected a merger between PASW, Inc., a company which had at the time of the merger, publicly traded common stock with limited operations, and VimetX, Inc., which became our principal operating subsidiary. As a result of this merger, the former securityholders of VimetX, Inc. came to own a majority of our outstanding common stock.

Under generally accepted accounting principles in the United States, the accompanying financial statements have been prepared as if VimetX, Inc., a company whose inception date was August 2, 2005, who is our predecessor for accounting purposes, had acquired PASW, Inc. on July 5, 2007. Accordingly, the accompanying statement of operations include the operations of VimetX, Inc. from August 2, 2005 to December 31, 2008 and the operations of PASW, Inc. from July 5, 2007 to December 31, 2008. The historical share activity of VimetX, Inc. has been retroactively restated to account for the 12.454788 to one exchange rate which was applicable to certain convertible instruments as explained in Note 10 and Note 11 and for our one for three reverse stock split which was implemented on October 29, 2007.

Our principal business activities to date are our efforts to commercialize our patent portfolio. We also conduct the remaining activities of PASW, Inc., which are generally limited to the collection of royalties on certain internet-based communications by a wholly owned Japanese subsidiary of PASW pursuant to the terms of a single license agreement. The revenue generated by this agreement is not significant.

Although we believe we may derive revenues in the future from our principal patent portfolio and are currently endeavoring to develop certain of those patents into marketable products, we have not done so to date. As such, we are in the development stage and consequently are subject to the risks associated with development stage companies, including the need for additional financings, the uncertainty that our licensing program development efforts will produce revenue-bearing licenses for us, the uncertainty that our development initiatives will produce successful commercial products as well as the uncertainty of marketing and customer acceptance of such products.

These financial statements are prepared on a going concern basis that contemplates the realization of assets and discharge of liabilities in the normal course of business. We have incurred net operating losses and negative cash flows from operations. At December 31, 2008, we had a deficit accumulated in the development stage of \$23,048,161. Management believes that the first half of 2009 average monthly cash requirement to fund our business is unlikely to change materially from 2008 levels and, as a result, anticipates that our cash balance at December 31, 2008 as supplemented by our completed common equity and warrants offering in January 2009 which raised approximately \$3,300,000 of net proceeds, will be insufficient to fund our operations for longer than through the end of our second quarter of 2009. The consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts and classification of liabilities that might be necessary should the Company be unable to continue as a going concern.

## **Note 2 Summary of Significant Accounting Policies**

### ***Basis of Presentation***

The consolidated financial statements include the accounts of the VimetX Holding Company, a development stage enterprise, and its wholly owned subsidiaries. All intercompany transactions have been eliminated.

These financial statements reflect the historical results of VimetX, Inc. and subsequent to the merger date of July 5, 2007, the historical consolidated results of VimetX Holding Corporation.

### ***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 reported period. Actual results could differ from those estimates.

### ***Revenue Recognition***

We recognize revenue in accordance with SEC Staff Accounting Bulletin 104. We are a licensor of software and generate revenue primarily from the one-time sales of licensed software. Generally, revenue is recognized upon shipment of the licensed software. For multiple element license arrangements, the license fee is allocated to the various elements based on fair value. When a multiple element arrangement includes rights to a post-contract customer support, the portion of the license fee allocated to each function is recognized ratably over the term of the arrangement.

### ***Cash and Cash Equivalents***

We consider all highly liquid investments purchased with original maturities of three months or less at the date of purchase to be cash equivalents.

### ***Property and Equipment***

Property and equipment are stated at historical cost, less accumulated depreciation and amortization. Depreciation and amortization are computed using the accelerated and straight line methods over the estimated useful lives of the assets, which range from five to seven years. Repair and maintenance costs are charged to expense as incurred.

### ***Concentration of Credit Risk and Other Risks and Uncertainties***

Our cash and cash equivalents are primarily maintained at one financial institution in the United States. Deposits held with this financial institution may exceed the amount of insurance provided on such deposits. The balances are insured by the Federal Deposit Insurance Corporation as of the date of this report up to \$250,000. During the year ended December 31, 2008 we had, at times, funds that were uninsured. The uninsured balance at December 31, 2008 was in excess of \$200,000. We have not experienced any losses on our deposits of cash and cash equivalents.

### ***Intangible Assets***

We record intangible assets at cost, less accumulated amortization. Amortization of intangible assets is provided over their estimated useful lives, which can range from 3 to 15 years, on either a straight line basis or as revenue is generated by the assets.

### ***Impairment of Long-Lived Assets***

We identify and record impairment losses on intangible and other long-lived assets used in operations when events and changes in circumstances indicate that the carrying amount of an asset might not be recoverable. Recoverability is measured by comparison of the anticipated future net undiscounted cash flows to the related assets' carrying value. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the projected discounted future net cash flows arising from the asset.

### ***Research and Development***

Research and development costs include expenses paid to outside development consultants and compensation related expenses for our engineering staff. Research and development costs are expensed as incurred.

### ***Income Taxes***

We account for income taxes under the asset and liability method. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to affect taxable income. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts expected to be realized.

Effective January 1, 2007, we have adopted FASB Interpretation No. 48 ("FIN 48"), Accounting for Uncertainty in Income Taxes using the prospective method allowed by FIN 48. The adoption of FIN 48 did not have a material impact on our financial statements.

### ***Fair Value of Financial Instruments***

Carrying amounts of our financial instruments, including cash and cash equivalents, accounts payable, notes payable, and accrued liabilities approximate their fair values due to their short maturities. The carrying amount of our minimum royalty payment obligation approximates fair value because it is recorded at a discounted calculation.

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

Our accounting for share-based compensation is in accordance with Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment," ("SFAS 123(R)") which requires the measurement and recognition of compensation expense in the statement of operations for all share-based payment awards made to employees and directors including employee stock-options based on estimated fair values. Using the modified retrospective transition method of adopting SFAS 123(R), the herein financial statements presented reflect compensation expense for stock-based awards as if the provisions of SFAS 123(R) had been applied from the date of inception.

In addition, as required by Emerging Issues Task Force Consensus No. 96-18, "*Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling Goods or Services,*" we record stock and options granted to non-employees at fair value of the consideration received or the fair value of the equity instruments issued as they vest over the performance period.

### ***Earnings Per Share***

SFAS No. 128, "*Earnings Per Share*" requires presentation of basic earnings per share ("Basic EPS") and diluted earnings per share ("*Diluted EPS*"). Basic earnings per share is computed by dividing earnings available to common stockholders by the weighted average number of outstanding common shares during the period. Diluted earnings per share is computed by dividing net income by the weighted average number of shares outstanding including potentially dilutive securities such as options, warrants and convertible debt. Since we incurred a loss for the period, any common stock equivalents have been excluded because their effect would be anti-dilutive.



### **Recent Accounting Pronouncements**

On March 19, 2008, the FASB issued SFAS No. 161, “*Disclosures about Derivative Instruments and Hedging Activities*”, an amendment of FASB Statement No. 133, or SFAS No. 161. SFAS No. 161 requires enhanced disclosures about an entity’s derivative and hedging activities. These enhanced disclosures will discuss (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity’s financial position, financial performance, and cash flows. SFAS No. 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. We have not determined the impact, if any SFAS No. 161 will have on our consolidated financial statements.

In December 2007, the Financial Accounting Standards Board, or FASB, issued SFAS No. 141(R), “*Business Combinations*” and SFAS No. 160, “*Accounting and Reporting of Noncontrolling Interests in Consolidated Financial Statements — an amendment to ARB No. 51.*” These Standards will significantly change the accounting and reporting for business combination transactions and noncontrolling (minority) interests in consolidated financial statements, including capitalizing at the acquisition date the fair value of acquired in-process research and development, and, remeasuring and writing down these assets, if necessary, in subsequent periods during their development. These new standards will be applied prospectively for business combinations that occur on or after January 1, 2009, except that presentation and disclosure requirements of SFAS 160 regarding noncontrolling interests shall be applied retroactively. The implementation of these standards is not expected to have a material impact on the consolidated statements of operations or financial position.

In December 2007, the FASB ratified EITF No. 07-1, “*Accounting for Collaborative Agreements.*” This standard provides guidance regarding financial statement presentation and disclosure of collaborative agreements, as defined, which includes arrangements regarding the developing and commercialization of products and product candidates. EITF 07-01 is effective as of January 1, 2009. Implementation of this standard is not expected to have a material impact on our consolidated statements of operations or financial position.

In June 2007, the FASB ratified EITF 07-3, “*Accounting for Nonrefundable Advance Payments for Goods or Services to be used in Future Research and Development Activities.*” This standard requires that nonrefundable advance payments for goods and services that will be used or rendered in future research and development activities pursuant to executory contractual arrangements be deferred and recognized as an expense in the period the related goods are delivered or services are performed. EITF No. 07-3 became effective as of January 1, 2008 and it did not have a material impact on our consolidated statements of operations or financial position upon adoption.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, or SFAS No. 157, “*Fair Value Measurements.*” SFAS No. 157 provides guidance for using fair value to measure assets and liabilities. It also responds to investors’ request for expanded information about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair valued measurements on earnings. SFAS No. 157 applies whenever standards require (or permit) assets or liabilities to be measured at fair value, and does not expand the use of fair value in any new circumstances. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years, with early adoption permitted, except for the impact of FASB Staff Position (FSP) 157-2. FSP 157-2 deferred the adoption of SFAS 157 for non financial assets and liabilities until years ended after November 15, 2008. Adoption of these SFAS No. 157 requirements did not have a material impact on our consolidated statement of operations or financial position.

### **Note 3 Property**

Our major classes of property and equipment were as follows:

	<b>December 31</b>	
	<b>2008</b>	<b>2007</b>
Office furniture	\$ 17,239	\$ 10,129
Computer equipment	61,209	48,827
Total	78,448	58,956
Less accumulated depreciation	(45,883)	(26,298)
	<u>\$ 32,565</u>	<u>\$ 32,658</u>

Depreciation expense for the years ended December 31, 2008 and 2007 was \$20,623 and \$18,609, respectively.

**Note 4 Patent Portfolio**

As of March 11, 2009, we had 12 issued U.S. and eight issued foreign technology related patents, in addition to pending U.S. and foreign patent applications. The term of our issued U.S. and foreign patents runs through the period 2019 to 2024. Most of our issued patents were acquired by our principal operating subsidiary, VimetX, Inc., from Science Applications International Corporation, or SAIC, pursuant to an Assignment Agreement dated December 21, 2006, and a Patent License and Assignment Agreement dated August 12, 2005, as amended on November 2, 2006, including documents prepared pursuant to the November amendment, and as further amended on March 12, 2008. We are required to make payments to SAIC based on the revenue generated from our ownership or use of the patents assigned to us by SAIC. Minimum annual royalty payments of \$50,000 are due beginning in 2008. Royalty amounts vary depending upon the type of revenue generating activities, and certain royalty categories are subject to maximums and other limitations. SAIC is entitled to receive a portion of the proceed revenues, monies or any form of consideration paid for the acquisition of VimetX or from the settlement of certain patent infringement claims of ours. We have granted SAIC a security interest in some of our intellectual property, including the patents and patent applications we obtained from SAIC, to secure these payment obligations.

Generally upon our default of our agreement with SAIC and certain other events, we are required to convey to SAIC our interests in the patents and patent applications acquired from SAIC without consideration.

At December 31, 2007, in accordance with SFAS 142, "Accounting for Goodwill and Other Intangible Assets", we recorded the fair value of the \$50,000 annual guaranteed payments we have agreed to pay to SAIC in 2008 through 2012 as a liability, calculated using a discount rate of 8%. This liability will accrue interest at the 8% rate during the period it is outstanding. We recorded a related asset equal in amount to the liability as an intangible asset which will be amortized over the expected revenue generating period of our agreement with SAIC. Amortization expense was \$48,000 in 2008 and \$0 in 2007.

As of December 31, 2008, the expected amortization of the intangible assets is as follows:

2009	\$	48,000
2010		48,000
2011		48,000
2012		48,000
Thereafter		12,000
Total	\$	<u>204,000</u>

As of December 31, 2008, the obligation matures as follows:

2009	\$	44,000
2010		40,000
2011		36,000
2012		32,000
Thereafter		52,000
Total	\$	<u>204,000</u>

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**Note 5 Commitments**

We lease our office facility under a non-cancelable operating lease that was amended in 2008 and ends in 2012. We recognize rent expense on a straight-line basis over the term of the lease. Rent expense for the years ended December 31, 2008 and 2007 was \$25,037 and \$14,925, respectively.

For the Year	Minimum Required Lease Payments in Period
2009	\$ 44,373
2010	54,595
2011	59,242
2012	30,202
	\$ 188,412

**Note 6 Stock Plan**

In 2005, VimetX, Inc. adopted the 2005 Stock Plan (the "Plan"), which was assumed by us upon the closing of the transaction between VimetX Holding Corporation and VimetX, Inc. on July 5, 2007. Our Board of Directors renamed this Plan the VimetX 2007 Stock Plan and our stockholders approved the Plan at our 2008 annual stockholders' meeting. The Plan provides for the granting of stock options and restricted stock units to employees and consultants of ours. Stock options granted under the Plan may be incentive stock options or nonqualified stock options. Incentive stock options ("ISO") may only be granted to our employees (including officers and directors). Nonqualified stock options ("NSO") may be granted to our employees and consultants.

Options under the Plan may be granted for period up to ten years and at prices no less than 85% of the estimated fair market value of the shares on the date of grant as determined by the board of directors, provided, however, that the exercise price of an ISO and NSO shall not be less than 100% or 85% of the estimated fair market value of the shares at the date of grant, respectively, and the exercise price of an ISO and NSO granted to a 10% shareholder shall not be less than 110% of the estimated fair value of the shares on the date of grant.

Activity under the Plan is as follows:

	Shares Available for Grant	Options Outstanding	
		Number of Shares	Weighted Average Exercise Price
<b>Shares reserved for the Plan at inception</b>	11,624,469	—	—
Restricted stock units granted	(3,321,277)	—	—
Options granted	—	—	—
Options exercised	—	—	—
Options cancelled	—	—	—
<b>Balance at December 31, 2005</b>	8,303,192	—	—
Restricted stock units granted	(1,058,657)	—	—
Options granted	(1,868,218)	1,868,218	\$ .24
Options exercised	—	—	—
Options cancelled	—	—	—

	Shares Available for Grant	Options Outstanding	
		Number of Shares	Weighted Average Exercise Price
<b>Balance at December 31, 2006</b>	5,376,317	1,868,218	\$ .24
Restricted stock units granted	—	—	—
Options granted	(2,324,925)	2,324,925	4.96
Options exercised	—	(124,548)	.24
Options cancelled	—	—	—
<b>Balance at December 31, 2007</b>	3,051,392	4,068,595	\$ 2.94
Restricted stock units granted	—	—	—
Options granted	(420,000)	420,000	3.42
Options exercised	—	—	—
Options cancelled	20,000	(20,000)	4.20
<b>Balance at December 31, 2008</b>	2,651,392	4,468,595	\$ 2.98

**Note 7 Stock-Based Compensation**

We account for equity instruments issued to employees in accordance with the provision of SFAS 123(R) which requires that such issuances be recorded at their fair value on the grant date. The recognition of the expense is subject to periodic adjustment as the underlying equity instrument vests.

We have elected to adopt the modified retrospective application method as provided by SFAS 123(R) and, accordingly, financial statement amounts for the periods presented herein reflect results as if the fair value method of expensing equity awards had been applied from inception.

Stock-based compensation expense is included in general and administrative expense for each period as follows:

Stock-Based Compensation by Type of Award	Year Ended December 31, 2008	Year Ended December 31, 2007	Cumulative Period from August 2, 2005 (Date of Inception) to December 31, 2008
Restricted stock units	\$ —	\$ —	\$ 930,130
Employee stock options	2,682,431	818,869	3,582,919
<b>Total stock-based compensation</b>	<b>\$ 2,682,431</b>	<b>\$ 818,869</b>	<b>\$ 4,513,049</b>

As of December 31, 2008, the unrecorded deferred stock-based compensation balance related to stock options was \$7,376,829, which will be amortized as expense over an estimate weighted average vesting amortization period of approximately 3.1 years.

The fair value of each option grant was estimated on the date of grant using the following weighted average assumptions:

	Year Ended December 31, 2008	Year Ended December 31, 2007
Volatility	190%	100%
Risk-free interest rate	4.21%	3.32%
Expected life	6.7 years	6.5 years
Expected dividends	0%	0%

Based on the Black-Scholes option pricing model, the weighted average estimated fair value of employee stock options granted was \$3.09 and \$4.02 during the year ended December 31, 2008 and 2007, respectively.

The expected life was determined using the simplified method outlined in Staff Accounting Bulletin No. 107 (“SAB 107”), taking the average of the vesting term and the contractual term of the option. Expected volatility of the stock options was based upon historical data and other relevant factors, such as the volatility of comparable publicly-traded companies at a similar stage of life cycle. We have not provided an estimate for forfeitures because we have no history of forfeited options and believe that all outstanding options at December 31, 2008 will vest. In the future, the Company may change this estimate based on actual and expected future forfeiture rates.

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The following table summarizes activity under the equity incentive plans for the indicated periods:

	Number of Shares	Weighted Average Exercise	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value
Outstanding at December 31, 2005	—	—		
Options granted	1,868,218	0.24		
Options exercised	—	—		
Options cancelled	—	—		
Outstanding at December 31, 2006	1,868,218	0.24		
Options granted	2,324,925	4.96		
Options exercised	(124,548)	0.24		
Options cancelled	—	—		
Outstanding at December 31, 2007	4,068,595	2.94		
Options granted	420,000	3.42		
Options exercised	—	—		
Options cancelled	(20,000)	4.20		
Outstanding at December 31, 2008	<u>4,468,595</u>	<u>\$ 2.98</u>	<u>8.7</u>	<u>\$ 2,160,633</u>

Intrinsic value is calculated at the difference between the market price of the Company's stock on the last trading day of the year (\$1.48) and the exercise price of the options. For options exercised, the intrinsic value is the difference between market price and the exercise price on the date of exercise.

The following table summarizes information about stock options outstanding at December 31, 2008:

Range of Exercise Price	Options Outstanding			Options Vested and Exercisable		
	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price
\$0.24	1,743,670	7.4	\$ 0.24	1,138,230	7.4	\$ 0.24
4.20	1,327,899	8.6	4.20	513,543	8.6	4.20
5.88-6.47	977,026	9.0	6.00	264,257	9.0	6.00
1.74-6.20	420,000	9.6	3.42	47,500	9.6	5.06
	<u>4,468,595</u>	<u>8.7</u>	<u>\$ 2.98</u>	<u>1,963,530</u>	<u>8.7</u>	<u>\$ 2.17</u>

**Note 8 Warrants**

During 2007, we issued warrants to purchase 266,667 shares of our common stock at \$0.75 per share. The warrants expire in 2012. In 2008, these warrants were exercised in cashless exercise transactions, as a result of which a total of 232,771 shares of our common stock were issued.

During 2007, we issued warrants to purchase 300,000 shares of our common stock at \$4.80 per share to the underwriter of our December 2007 stock issuance. Those warrants expire in 2012.

**Note 9 Earnings Per Share**

Basic earnings per share is based on the weighted average number of shares outstanding for a period. Diluted earnings per share is based upon the weighted average number of shares and potentially dilutive common shares outstanding. Potential common shares outstanding principally include stock options, warrants, restricted stock units and other equity awards under our stock plan. Since the Company has incurred losses, the effect of any common stock equivalent would be anti-dilutive.

The table below sets forth the basic loss per share calculations (in 000s, except per share information). Because we incurred net losses for each period presented, no diluted per share amounts have been presented.

	<b>Period Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
Net loss	\$ (12,072)	\$ (8,692)
Weighted average number of shares outstanding	34,875	24,312
Basic earnings (loss) per share	\$ (0.35)	\$ (0.36)

For the years ended December 31, 2008 and 2007, there were the following stock equivalents:

	<b>2008</b>	<b>2007</b>
	Options	4,468,595
Warrants	300,000	566,667

**Note 10 Preferred Stock**

Our Amended and Restated Certificate of Incorporation, as amended in October 2007, authorizes us to issue 10,000,000 shares of \$0.0003 par value per share preferred stock having rights, preferences and privileges to be designated by our Board of Directors. There were no shares of preferred stock outstanding at December 31, 2008. All of the VimetX, Inc. preferred stock converted into VimetX, Inc. common stock on a 1-for-1 basis immediately prior to the merger between us and VimetX, Inc, so at the date of the merger in 2007, each preferred share of VimetX, Inc. converted to 12.454788 shares of our common stock.

At December 31, 2008, the Series A preferred stock was not mandatorily redeemable.

**Note 11 Common Stock**

Each share of common stock has the right to one vote. The holders of common stock are entitled to receive dividends whenever funds are legally available and when declared by the Board of Directors, subject to the prior rights of holders of all classes of stock outstanding having priority rights as to dividends. No dividends have been declared from inception through December 31, 2008. Our restated articles of incorporation authorizes us to issue up to 100,000,000 shares of \$.0001 par value common stock.

We have issued Restricted Stock Units ("RSUs") to employees and consultants as discussed in Note 7.

All share amounts have been retroactively restated to reflect the conversion rate of 12.454788/1 used to effect the merger between VimetX, Inc. and VimetX Holding Corporation in 2007 and the reverse stock split of 1-for-3 effective in 2007.

**Note 12 Employee Benefit Plan**

We sponsor a defined contribution, 401K plan, covering substantially all our employees. The Company's matching contribution to the plan in 2008 was approximately \$34,000 and \$5,600 in 2007. There was no plan in 2006 or 2005.

**Note 13 Convertible Debt**

In February 2007 we borrowed \$500,000 from a group of existing shareholders. The note accrued interest at 6% and was converted into our common stock at \$.75 per share upon the completion of the transaction in which VimetX, Inc. came to be our wholly owned subsidiary, or the "Transaction". Also in February 2007, we borrowed \$1,000,000 from a third party. That note accrued interest at 10% and was converted into our common stock at \$.75 per share upon the completion of the Transaction.

**Note 14 Short Term Borrowings**

During 2007 we borrowed funds on a short-term basis. In June 2007 we borrowed \$50,000 at 10% interest. These funds were repaid in July 2007. In December 2007, we borrowed \$200,000 in the aggregate from two investors. These funds were repaid, with an aggregate of \$2,000 interest, in December 2007.

**Note 15 Income Taxes**

We have Federal and state net operating loss carryforwards of approximately \$9,100,000 available to offset future taxable income. The Federal and state loss carryforwards expire beginning in 2025 and 2015 respectively. There are restrictions on our ability to utilize these benefits in any one year. As a result, we have fully reserved any deferred tax benefit from these net operating loss carryforwards.

We have Federal and state tax credit carryforwards of approximately \$300,000 to reduce future income tax expense. The Federal tax credits expire beginning in 2025. The state tax credits currently do not have an expiration date.

The components of the income tax provision are as follows:

	<b>Period Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
Provision for income taxes at the federal & state statutory rate	\$ (4,100,000)	\$ (3,200,000)
Stock-based compensation	900,000	300,000
Research and development credits	(100,000)	(100,000)
Valuation allowance	3,300,000	3,000,000
Tax provision	<u>\$ 0</u>	<u>\$ 0</u>

The elements of deferred taxes are as follows:

	<b>Period Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
Tax benefit of net operating loss carryforwards	\$ 7,000,000	\$ 3,400,000
Research and development credits	400,000	300,000
Subtotal	<u>7,400,000</u>	<u>3,700,000</u>
Less valuation allowance	<u>(7,400,000)</u>	<u>(3,700,000)</u>
	<u>\$ 0</u>	<u>\$ 0</u>

The change in the deferred tax valuation allowance was an increase of \$3,700,000 and \$3,000,000 in the periods ended 2008 and 2007, respectively.

#### **Note 16 Merger of VirnetX, Inc. and VirnetX Holding Corporation**

In July 2007, VimetX Holding Corporation consummated a reverse triangular merger in which the Company's wholly-owned subsidiary merged with and into VimetX, Inc. with VimetX, Inc. as the surviving Corporation to the merger. As a result of the merger VimetX, Inc. became a wholly-owned subsidiary of the Company, and the pre-merger shareholders of VimetX Inc. exchanged their shares in VimetX, Inc. for shares of the common stock of the Company. As a result, the VimetX, Inc. is considered the acquiror of VimetX Holding Corporation for accounting purposes.

The key terms of the merger include the following:

- Our officers and directors, except for the chief financial officer, were replaced upon completion of the transaction so that the officers and directors of VimetX, Inc. became our officers and directors.
- VimetX, Inc.'s convertible notes payable for \$1,000,000 and \$500,000 were converted into our common stock in July 2007.
- An escrow account containing proceeds of \$3,000,000 was released from escrow in exchange for our issuance of common stock in July 2007.
- We issued 29,551,398 shares of our common stock and options to purchase 1,785,186 shares of common stock to the pre-merger shareholders, convertible note holders and option holders of VimetX, Inc. in exchange for 100% of the issued and outstanding capital stock and securities of VimetX, Inc. Additionally, we issued to MDB Capital Group LLC and its affiliates, warrants to purchase an aggregate of 266,667 shares of our common stock of the Company pursuant to the provisions of the MDB Service Agreement, which we assumed from VimetX, Inc. in connection with the merger.

#### **Note 17 Subsequent Event**

In January 2009, we closed an offering of 2,470,000 shares of our common stock plus warrants to purchase 1,235,000 shares of common stock at \$1.50 per share, warrants to purchase 1,235,000 shares of common stock at \$3.00 per share and warrants to purchase 1,235,000 shares of common stock at \$4.00 per share. The offering at \$1.50 per unit raised gross proceeds of approximately \$3,700,000 before deducting the underwriter's fees and other costs of the offering. The deferred offering costs at December 31, 2008 were charged against the funds raised. The net cash raised was approximately \$3,300,000.

#### **Note 18 Litigation**

We believe Microsoft Corporation is infringing certain of our patents. Accordingly, we commenced a lawsuit against Microsoft on February 15, 2007 by filing a complaint in the United States District Court for the Eastern District of Texas, Tyler Division. Pursuant to the complaint, we allege that Microsoft infringes two of our U.S. patents: U.S. Patent No. 6,502,135 B1, entitled "Agile Network Protocol for Secure Communications with Assured System Availability," and U.S. Patent No. 6,839,759 B2, entitled "Method for Establishing Secure Communication Link Between Computers of Virtual Private Network Without User Entering Any Cryptographic Information." On April 5, 2007, we filed an amended complaint specifying certain accused products at issue and alleging infringement of a third, recently issued U.S. patent: U.S. Patent No. 7,188,180 B2, entitled "Method for Establishing Secure Communication Link Between Computers of Virtual Private Network." We are seeking both damages, in an amount subject to proof at trial, and injunctive relief. Microsoft answered the amended complaint and asserted counterclaims against us on May 4, 2007. Microsoft counterclaimed for declarations that the three patents are not infringed, are invalid and are unenforceable. Microsoft seeks an award of its attorneys' fees and costs. We filed a reply to Microsoft's counterclaims on May 24, 2007. Discovery has begun and the trial is scheduled to begin on October 12, 2009. We have served our infringement contentions directed to certain of Microsoft's operating system and unified messaging and collaboration applications. On March 31, 2008, Microsoft filed a Motion to Dismiss for lack of standing, which was denied by the court



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pursuant to an order dated June 3, 2008. Also pursuant to that court decision, on June 10, 2008, SAIC joined us in our lawsuit as a plaintiff. On November 19, 2008, the court granted our motion to amend our infringement contentions, permitting us to provide increased specificity and citations to Microsoft's proprietary documents and source code to support our infringement case against Microsoft's accused products, including, among other things, Windows XP, Vista, Server 2003, Server 2008, Live Communication Server, Office Communication Server and Office Communicator. Microsoft was ordered to provide further information regarding its non-infringement contentions and invalidity contentions in light of the amended infringement contentions. Microsoft was also ordered to provide additional e-mail discovery to VirmetX. Microsoft was not required to search disaster recovery tapes for additional information. On February 17, 2009, a Markman hearing on claim construction was conducted and the parties are currently awaiting the Court's order with respect to the hearing.

Although we believe Microsoft infringes three of our patents and we intend to vigorously prosecute this case, at this stage of the litigation the outcome cannot be predicted with any degree of reasonable certainty. Additionally, the Microsoft litigation will be costly and time-consuming, and we can provide no assurance that we will obtain a judgment against Microsoft for damages and/or injunctive relief. Should the District Court issue a judgment in favor of Microsoft, and in connection with such judgment determine that we had acted in bad faith or with fraudulent intent, or we were otherwise found to have exhibited inequitable conduct, the Court could award attorney fees to Microsoft, which would be payable by us.

Because the outcome of this litigation cannot be estimated at this time, we have made no provision for gain or expenses in the accompanying financial statements.

**Note 19 Quarterly Financial Information (unaudited)**

	<u>First</u>	<u>Second</u>	<u>Third</u>	<u>Fourth</u>
	<b>(amounts in thousands except per share)</b>			
<b>2008</b>				
Revenue	\$ 33	\$ 51	\$ 24	\$ 26
Loss from operations	(3,102)	(3,096)	(2,947)	(3,077)
Net loss	(3,032)	(3,049)	(2,923)	(3,068)
Net loss per common share	\$ (0.09)	\$ (0.09)	\$ (0.08)	\$ (0.08)
<b>2007</b>				
Revenue	\$ 0	\$ 0	\$ 47	\$ 28
Loss from operations	(410)	(1,526)	(2,589)	(4,125)
Net loss	(410)	(1,572)	(2,566)	(4,144)
Net loss per common share	\$ (0.02)	\$ (0.10)	\$ (0.09)	\$ (0.15)

**Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.**

None

**Item 9A. Controls and Procedures.**

**Evaluation of Disclosure Controls and Procedures**

We evaluated the design and operating effectiveness of our disclosure controls and procedures as of December 31, 2008, under the supervision and with the participation of our management, pursuant to Rule 13a-15(b) of the Securities Exchange Act of 1934, as amended (the “Securities Exchange Act”). Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures as defined in Rule 13a-15(e) were effective in providing the requisite reasonable assurance that material information required to be disclosed in the reports that we file or submit under the Securities Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding the required disclosure.

**Management’s Report on Internal Control Over Financial Reporting**

Our management is responsible for establishing and maintaining an adequate system of internal control over our financial reporting, pursuant to Rule 13a-15(c) of the Securities Exchange Act. This system is intended to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States.

A company’s internal control over financial reporting includes policies and procedures that: (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company, (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company, and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company’s assets that could have a material effect on the financial statements.

In 2007, our management selected the framework in *Internal Control — Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”), to conduct an evaluation of the effectiveness of the Company’s internal control over financial reporting. The COSO framework summarizes each of the components of a company’s internal control system, including the: (i) control environment, (ii) risk assessment, (iii) information and communication, and (iv) monitoring (collectively, the “entity-level controls”), as well as a company’s control activities (“process-level controls”). In addition to utilizing substantial internal resources, management also engaged an outside consulting firm to assist in various aspects of its evaluation and compliance efforts.

Based on this assessment, our management believes that, as of the end of our most recently completed fiscal year, our internal control over financial reporting was effective.

This annual report does not include an attestation report of the Company’s registered public accounting firm regarding internal control over financial reporting. Management’s report was not subject to attestation by the Company’s registered public accounting firm pursuant to temporary rules of the SEC that permit the Company to provide only management’s report in this annual report.

**Changes in Internal Control**

There were no changes in our internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Rule 13a-15 or Rule 15d-15 of the Securities Exchange Act that occurred during our fourth fiscal quarter of 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Item 9B. Other Information.**

Not applicable.

**PART III**

Certain information required by Part III is omitted from this report because we will file a definitive proxy statement within 120 days after the end of its fiscal year pursuant to Regulation 14A (the "Proxy Statement") for our 2009 annual meeting of stockholders, and the information included in the Proxy Statement is incorporated herein by reference.

**Item 10. Directors, Executive Officers and Corporate Governance.**

The information required by this item is incorporated by reference to the information set forth in our Definitive Proxy Statement, expected to be filed within 120 days of our fiscal year end.

**Item 11. Executive Compensation.**

The information required by this item is incorporated by reference to the information set forth in our Definitive Proxy Statement, expected to be filed within 120 days of our fiscal year end.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters Equity Compensation Plan Information.**

The information required by this item is incorporated by reference to the information set forth in our Definitive Proxy Statement, expected to be filed within 120 days of our fiscal year end.

**Item 13. Certain Relationships and Related Transactions, and Director Independence.**

The information required by this item is incorporated by reference to the information set forth in our Definitive Proxy Statement, expected to be filed within 120 days of our fiscal year end.

**Item 14. Principal Accounting Fees and Services.**

The information required by this item is incorporated by reference to the information set forth in our Definitive Proxy Statement, expected to be filed within 120 days of our fiscal year end.

**PART IV**

**Item 15. Exhibits and Financial Statement Schedules.**

(a) The following documents are filed as part of this Annual Report on Form 10-K:

(1) *Financial Statements*:

- Report of Independent Registered Public Accounting Firm
- Consolidated Balance Sheets as of December 31, 2008 and 2007

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- Consolidated Statements of Operations for the years Ended December 31, 2008 and 2007 and for the period from August 2, 2005 (inception) to December 31, 2008
- Consolidated Statements of Changes in Stockholders' Equity (Deficit) for the years Ended December 31, 2008 and 2007 and for the period from August 2, 2005 (inception) to December 31, 2008
- Consolidated Statements of Cash Flows for the years Ended December 31, 2008 and 2007 and for the period from August 2, 2005 (inception) to December 31, 2008
- Notes to Financial Statements

### (2) *Financial Statement Schedule:*

Financial statement schedules are omitted because they are not applicable or the required information is shown in the financial statements or notes thereto.

All other schedules are omitted because of the absence of conditions under which they are required or because the required information is given in the financial statements or the notes thereto.

### (3) *Exhibits:*

<b>Exhibit Number</b>	<b>Description</b>
2.1	Agreement and Plan of Merger of PASW, Inc., a Delaware corporation, and PASW, Inc., a California corporation dated May 25, 2007.(1)
2.2	Certificate of Merger filed with the Secretary of State of the State of Delaware on May 30, 2007.(1)
2.3	Agreement and Plan of Merger and Reorganization among PASW, Inc., VimetX Acquisition, Inc. and VimetX, Inc. dated as of June 12, 2007.(1)
3.1	Amended and Restated Certificate of Incorporation of the Company.(1)
3.2	By-Laws of the Company.(1)
4.1	Form of Common Stock Purchase Warrant Issued to Gilford Securities Incorporated.(1)
4.2	Form of Warrant Agency Agreement by and between the Company and Corporate Stock Transfer, Inc. as Warrant Agent.(2)
4.3	Form of Underwriter's Warrant.(2)
10.1	Form of Indemnification Agreement, dated as of July 5, 2007, by and between the Company and each of Kendall Larsen, Edmund C. Munger, Scott C. Taylor, Michael F. Angelo, Thomas M. O'Brien and William E. Sliney.(1)
10.2	Patent License and Assignment Agreement by and between the Company and Science Applications International Corporation, dated as of August 12, 2005.(1)
10.3	Security Agreement by and between the Company and Science Applications International Corporation, dated as of August 12, 2005.(1)
10.4	Amendment No. 1 to Patent License and Assignment Agreement by and between the Company and Science Applications International Corporation, dated as of November 2, 2006.(1)
10.5	Assignment Agreement between the Company and Science Applications International Corporation, dated as of December 21, 2006.(1)
10.6	Professional Services Agreement by and between the Company and Science Applications International Corporation, dated as of August 12, 2005.(1)
10.7	Lease Agreement by and between the Company and Granite Creek Business Center, dated as of March 15, 2006, as amended in April 2007 and April 2008.
10.8	Master Consulting Agreement by and between the Company and Magenic Technologies, Inc, dated as of February 23, 2006.(1)
10.9	Voting Agreement among the Company and certain of its stockholders, dated as of December 12, 2007.(5)
10.10	Amendment No. 2 to Patent License and Assignment Agreement by and between the Company and Science Applications International Corporation, dated as of March 12, 2008.(3)
10.11	IP Brokerage Agreement with ipCapital Group, Inc., effective as of March 13, 2008.(3)

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<b>Exhibit Number</b>	<b>Description</b>
10.12	Engagement Letter for Strategic Intellectual Property Licensing and Training with ipCapital Group, Inc., dated as of March 12, 2008.(3)
10.13	2007 Stock Plan and related agreements.(4)
21.1	Subsidiaries of VimetX Holding Corporation
23.1	Consent of Farber Hass Hurley LLP, Independent Registered Public Accounting Firm
31.1	Chief Executive Officer Certification Pursuant to Rule 13a-14(a) of the Securities Exchange Act.
31.2	Chief Financial Officer Certification Pursuant to Rule 13a-14(a) of the Securities Exchange Act.
32.1	Chief Executive Officer Certification pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Chief Financial Officer Certification pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

- (1) Incorporated herein by reference to the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on July 12, 2007.
- (2) Incorporated herein by reference to the Company's Registration Statement on Form S-1/A filed with the Securities and Exchange Commission on January 26, 2009.
- (3) Incorporated herein by reference to the Company's Form 8-K filed with the Securities and Exchange Commission on March 18, 2008.
- (4) Incorporated herein by reference to the Company's Registration Statement on Form S-8 filed with the Securities and Exchange Commission on March 25, 2008.
- (5) Incorporated herein by reference to the Company's Registration Statement on Form SB-2/A filed with the Securities and Exchange Commission on December 17, 2007.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this Annual Report on Form 10-K to be signed on its behalf by the undersigned, thereunto duly authorized.

VimetX Holding Corporation

By: /s/ Kendall Larsen  
Name: Kendall Larsen  
Title: Chief Executive Officer and President

Dated: March 31, 2009

**POWER OF ATTORNEY**

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Kendall Larsen his or her attorney-in-fact, with full power of substitution, for him or her in any and all capacities, to sign any amendments to this Report on Form 10-K, and to file the same, with exhibits thereto and other documents in connection therewith with the Securities and Exchange Commission, hereby ratifying and confirming all that said attorney-in-fact, or his or her substitute or substitutes may do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this Annual Report on Form 10-K has been signed below by the following persons on behalf of the registrant and in the capacities indicated.

<u>Signature</u>	<u>Capacity</u>	<u>Date</u>
<u>/s/ Kendall Larsen</u> Kendall Larsen	Director, Chief Executive Officer and President <i>(Principal Executive Officer)</i>	March 31, 2009
<u>/s/ William E. Sliney</u> William E. Sliney	Chief Financial Officer <i>(Principal Financial Officer and Principal Accounting Officer)</i>	March 31, 2009
<u>/s/ Edmund C. Munger</u> Edmund C. Munger	Director	March 31, 2009
<u>/s/ Scott C. Taylor</u> Scott C. Taylor	Director	March 31, 2009
<u>/s/ Michael F. Angelo</u> Michael F. Angelo	Director	March 31, 2009
<u>/s/ Thomas M. O'Brien</u> Thomas M. O'Brien	Director	March 31, 2009

**EXHIBIT INDEX**

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- (5) Incorporated herein by reference to the Company's Registration Statement on Form SB-2/A filed with the Securities and Exchange Commission on December 17, 2007.

STANDARD OFFICE/MULTI-TENANT LEASE — NNN

by and between

GRANITE CREEK BUSINESS CENTER

("Landlord")

and

VimetX, INC.

("Tenant")

For the approximately 995 sq. ft. premises at  
5615 Scotts Valley Drive, Suite 110, Scotts Valley, California

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## LEASE AGREEMENT

**1. Parties.** THIS LEASE (the "Lease"), dated March 15, 2006 is entered into by and between Granite Creek Business Center, a California general partnership ("Landlord"), whose address is c/o Toeniskoetter & Breeding, Inc., Development, 1960 The Alameda, San Jose, CA 95126 and VimetX Inc., a Delaware Corporation ("Tenant"), whose address is 157 Provincetown Court, Aptos, California 95003.

**2. Premises.** Landlord hereby leases to Tenant and Tenant hereby leases from Landlord those certain premises consisting of approximately nine hundred ninety-five (995) rentable square feet, as shown in EXHIBIT A (the "Premises") in that certain building, commonly known as 5615 Scotts Valley Drive (the "Building"), as further defined in Paragraph 3.B., in the City of Scotts Valley (the "City"), County of Santa Cruz, (the "County"), California, together with a right in common to the Common Area as defined in Paragraph 3.D., and a right in common to the Outside Area, as defined in Paragraph 3.1. Tenant's right to use the Common Area and Outside Area shall be a right in common with other tenants of the Building.

**3. Definition.** The following terms shall have the following meanings in this Lease:

A. **Alterations.** Any alterations, additions or improvements made in, on or about the Building or the Premises after the Commencement Date.

B. **Building.** That certain building on the Project consisting of approximately thirty-two thousand (32,000) rentable square feet.

C. **Commencement Date.** The Commencement Date of this Lease shall be the first day of the Term determined in accordance with Paragraph 4.A.

D. **Common Area.** All areas and facilities within the Building provided and designated by Landlord for the general use and convenience of Tenant and other tenants and occupants of any part of the Building, subject to the reasonable rules and regulations and changes therein from time to time promulgated by Landlord governing the use of the Common Area.

E. **HVAC.** Heating, ventilating and air conditioning.

F. Interest Rate. Twelve percent (12%) per annum, however, in no event to exceed the maximum rate of interest permitted by law.

G. Landlord's Agents. Landlord's authorized agents, partners, subsidiaries, directors, officers, and employees.

H. Monthly Rent. The rent payable pursuant to Paragraph 5.A., as adjusted from time to time pursuant to the terms of this Lease.

I. Outside Area. All areas and facilities within the Project, exclusive of the interior of the Building and the Adjacent Buildings, provided and designated by Landlord for the general use and convenience of Tenant and other tenants and occupants of the Project, subject to the reasonable rules and regulations and changes therein from time to time promulgated by Landlord governing the use of the Outside Area.

J. Project. That certain real property described in EXHIBIT B consisting of approximately 5.35 acres, upon which are located the Building, together with two (2) buildings of approximately fifty-eight thousand (58,000) total rentable square feet (the "Adjacent Buildings").

K. Real Property Taxes. Any form of assessment, property tax, fee, rent tax, or penalty (if a result of Tenant's delinquency), imposed by any authority having the direct or indirect power to tax, or by any city, county, state or federal government or any improvement or other district or division thereof, whether such tax is: (i) determined by the area of the Project or any part thereof or the rent and other sums payable hereunder by Tenant or by other tenants; (ii) upon any legal or equitable interest of Landlord in the Project or the Premises or any part thereof; (iii) upon this transaction or any document to which Tenant is a party creating or transferring any interest in the Project; (iv) levied or assessed in lieu of, in substitution for, or in addition to, existing or additional taxes against the Project whether or not now customary or within the contemplation of the parties; or (v) surcharged against the parking area.

L. Rent. Monthly Rent plus the Additional Rent defined in Paragraph 5.B.

M. Security Deposit. That amount paid by Tenant pursuant to Paragraph 7.

N. Sublet. Any transfer, sublet, assignment, license or concession agreement, change of ownership, mortgage, or hypothecation of this Lease or the Tenant's interest in the Lease or in and to all or a portion of the Premises.

O. Subrent. Any consideration of any kind received, or to be received, by Tenant from a subtenant if such sums are related to Tenant's interest in this Lease or in the Premises, including, but not limited to, bonus money and payments (in excess of book value) for Tenant's assets.

P. Subtenant. The person or entity with whom a Sublet agreement is proposed to be or is made.

Q. Tenant Improvements. Those certain improvements to the Premises to be constructed by Landlord pursuant to Paragraph 9.

R. Tenant Improvements Allowance. That allowance to be provided by Landlord for construction of the Tenant Improvements.

S. Tenant's Percentage.

(i) Tenant's Building Percentage. The percentage of the area of the Premises to the total area of the Building. Tenant's Building Percentage is agreed to be three and 11/100 percent (3.11%) for the purpose of this Lease.

(ii) Tenant's Project Percentage. The percentage of the area of the Premises to the total area of all of the buildings on the Project. Tenant's Project Percentage is agreed to be one and 11/100 percent (1.11%) for the purpose of this Lease.

T. Tenant's Personal Property. Tenant's trade fixtures, furniture, equipment and other personal property in the Premises.

U. Term. The term of this Lease set forth in Paragraph 4.A., as it may be extended hereunder pursuant to any options to extend granted herein.

V. Consent. Where consent is required herein by either party, such consent shall not be unreasonably withheld or delayed.

**4. Lease Term.**

A. Term. The Term of this Lease shall be twelve (12) months, commencing April 1, 2006 (the "Commencement Date") and ending March 31, 2007, subject to any sooner termination of this Lease pursuant to the terms hereof. Tenant agrees that if Landlord, for any reason whatsoever, is unable to deliver possession of the Premises by April 1, 2006, Landlord shall not be liable to Tenant for any loss or damage therefrom, nor shall this Lease be void or voidable. In such event, the Commencement Date, termination date and all other dates of this Lease shall be extended to conform to the date of Landlord's tender of possession of the Premises to Tenant and Tenant shall not be obligated to pay Monthly Rent or other sums due Landlord hereunder until possession of the Premises is tendered to Tenant.

B. Early Entry. If Tenant is permitted to enter the Premises prior to the Commencement Date for the purpose of fixturing or any other purpose permitted by Landlord, such early entry shall be at Tenant's sole risk and subject to all the terms and provisions hereof, except for the payment of Rent, which shall commence on the Commencement Date. Landlord shall have the right to impose such additional conditions on Tenant's early entry as Landlord shall deem appropriate, and shall further have the right to require that Tenant execute an early entry agreement containing such conditions prior to Tenant's early entry.

**5. Rent.**

A. Monthly Rent. Tenant shall pay to Landlord, in lawful money of the United States, for each calendar month of the Term, net Monthly Rent in advance, on the first day of each calendar month, without abatement, deduction, claim, offset, prior notice or demand in accordance with the schedule set forth below. Additionally, Tenant shall pay, as and with the net Monthly Rent, Tenant's Building Percentage of the estimated monthly Common Area Expenses and Tenant's Project Percentage of the estimated monthly Outside Area Expenses, as set forth in Paragraph 17.C., and Tenant's Building Percentage of the monthly cost of insurance premiums required pursuant to Paragraph 21.C., as adjusted from time to time hereunder. Tenant shall deposit with Landlord upon execution of this Lease One Thousand One Hundred Forty-Four and 25/100 Dollars (\$1,144.25) to be applied toward the net Monthly Rent due for the first month of the Term.

Months of Term	Net Monthly Rent
April 1, 2006 – May 31, 2006	\$ 0.00*
June 1, 2006 – October 31, 2006	\$1,144.25/month
November 1, 2006 – March 31, 2007	\$1,243.75/month

\* Triple net expenses to be paid during free rent period

B. **Additional Rent.** All monies required to be paid by Tenant under this Lease, including, without limitation, Real Property Taxes pursuant to Paragraph 15, Outside Area and Common Area Expenses pursuant to Paragraph 17, and insurance premiums pursuant to Paragraph 21, shall be deemed Additional Rent.

**6. Late Payment Charges.** Tenant acknowledges that late payment by Tenant to Landlord of Rent and other charges provided for under this Lease will cause Landlord to incur costs not contemplated by this Lease, the exact amount of such costs being extremely difficult or impracticable to fix. Therefore, if any installment of Rent or any other charge due from Tenant is not received by Landlord within five (5) days of becoming due, then Tenant shall pay to Landlord an additional sum equal to five percent (5%) of the amount overdue as a late charge. The parties agree that this late charge represents a fair and reasonable estimate of the costs that Landlord will incur by reason of the late payment by Tenant.

**Initials:**

Landlord      Tenant

**7. Security Deposit.** Upon execution of this Lease, Tenant shall deposit with Landlord the sum of One Thousand Two Hundred Forty Three and 75/100 Dollars (\$1,243.75) as a Security Deposit. The Security Deposit shall be held by Landlord as security for the full and faithful performance of every provision of this Lease to be performed by Tenant. If Tenant defaults with respect to any provision of this Lease, Landlord may apply all or any part of the Security Deposit for the payment of any Rent or other sum in default, the repair of such damage to the Premises or the payment of any other amount which Landlord may spend or become obligated to spend by reason of Tenant's default or to compensate Landlord for any other loss or damage which Landlord may suffer by reason of Tenant's default to the full extent permitted by law. If any portion of the Security Deposit is so applied, Tenant shall, within ten (10) days after written demand therefor, deposit cash with Landlord in an amount sufficient to restore the Security Deposit to its original amount. If Tenant is not otherwise in default, the Security Deposit or any balance thereof shall be returned to Tenant within thirty (30) days after the later of the termination of the Lease or the surrender of the Premises by Tenant.

**8. Holding Over.** If Tenant remains in possession of all or any part of the Premises after the expiration of the Term, with the express or implied consent of Landlord, such tenancy shall be month-to-month only and shall not constitute a renewal or extension for any further term. If Tenant remains in possession either with or without Landlord's consent, Monthly Rent shall be increased to an amount equal to one hundred fifty percent (150%) of the Monthly Rent payable during the last month of the Term, and any other sums due under this Lease shall be payable in the amount and at the times specified in this Lease. Such month-to-month tenancy shall be subject to every other term, condition, and covenant contained herein.

**9. Tenant Improvements.** None – Premises delivered in as-is condition.

**10. Condition of Premises.** By taking possession of the Premises, Tenant shall be deemed to have accepted the Premises in good, clean and completed condition and repair, subject to all applicable laws, codes and ordinances. Any damage to the Premises caused by Tenant's move-in shall be repaired or corrected by Tenant, at its expense. Tenant acknowledges that neither Landlord nor its Agents have made any representations or warranties as to the suitability or fitness of the Premises for the conduct of Tenant's business or for any other purpose, nor has Landlord or its Agents agreed to undertake any Alterations or construct any Tenant Improvements to the Premises except as expressly provided in this Lease.

**11. Use of the Premises.**

A. Tenant's Use. Tenant shall use the Premises solely for general office purposes and shall not use the Premises for any other purpose without obtaining the prior written consent of Landlord.

B. Compliance.

(i) Tenant shall not use the Premises or suffer or permit anything to be done in or about the Premises or the Project which will in any way conflict with any law, statute, zoning restriction, ordinance or governmental law, rule, regulation or requirement of public authorities now in force or which may hereafter be in force, relating to or affecting the condition, use or occupancy of the Premises or the Project. Tenant shall not commit any public or private nuisance or any other act or thing which might or would disturb the quiet enjoyment of any other tenant of Landlord or any occupant of nearby property. Tenant shall place no loads upon the floors, walls or ceilings in excess of the maximum designed load determined by Landlord or which endanger the structure; nor place any harmful liquids in the drainage systems; nor dump or store waste materials or refuse or allow such to remain outside the Building proper, except in the enclosed trash areas provided. Tenant shall not store or permit to be stored or otherwise placed any other material of any nature whatsoever outside the building.

(ii) In particular, Tenant, at its sole cost, shall comply with all laws relating to the storage, use and disposal of hazardous, toxic or radioactive matter, including those materials identified in Sections 66680 through 66685 of Title 22 of the California Administrative Code, Division 4, Chapter 30 ("Title 22") as they may be amended from time to time (collectively "Toxic Materials"). If Tenant does store, use or dispose of any Toxic Materials, Tenant shall notify Landlord in writing at least ten (10) days prior to their first appearance on the Premises. Tenant shall be solely responsible for and shall defend, indemnify and hold Landlord and its Agents harmless from and against all claims, costs and liabilities, including attorneys' fees and costs, arising out of or in connection with its storage, use and disposal of Toxic Materials. Tenant shall further be solely responsible for and shall defend, indemnify and hold Landlord and its Agents harmless from and against any and all claims, costs, and liabilities, including attorneys' fees and costs, arising out of or in connection with the removal, clean-up and restoration work and materials necessary to return the Premises and the Project and any other property of whatever nature to their condition existing prior to the appearance of the Toxic Materials on the Premises. Tenant's obligations hereunder shall survive the termination of this Lease.

**12. Quiet Enjoyment.** Landlord covenants that Tenant, upon performing the terms, conditions and covenants of this Lease, shall have quiet and peaceful possession of the Premises as against any person claiming the same by, through or under Landlord.

**13. Alterations.** After the Commencement Date, Tenant shall not make or permit any Alterations in, on or about the Premises, except for nonstructural Alterations that do not impact the Building systems nor exceed One Thousand Dollars (\$1,000.00) in cost, without the prior written consent of Landlord, and according to plans and specifications approved in writing by Landlord, which consent shall not be unreasonably withheld. Notwithstanding the foregoing Tenant shall not, without the prior written consent of Landlord, make any: (i) Alterations to the exterior of the Building; (ii) Alterations to and penetrations of the roof of the Building; and (iii) Alterations visible from outside the Premises, including the Common Area, to which Landlord may withhold Landlord's consent on wholly aesthetic grounds.

All Alterations shall be installed at Tenant's sole expense, in compliance with all applicable laws, by a licensed contractor, shall be done in a good and workmanlike manner conforming in quality and design with the Premises existing as of the Commencement Date, and shall not diminish the value of either the Building or the Premises. All Alterations made by Tenant shall be and become the property of Landlord upon installation and shall not be deemed Tenant's Personal Property; provided, however, that if Landlord informed Tenant at the time of its approval of any Alterations that Tenant would be required to remove such Alterations from the Premises at the expiration or sooner termination of this Lease, then Tenant shall, at Tenant's expense, remove such Alterations from the Premises at the expiration or sooner termination of this Lease and restore the Premises to their condition existing prior to the installation of such Alterations. Notwithstanding any other provision of this Lease, Tenant shall be solely responsible for the maintenance and repair of any and all Alterations made by it to the Premises. Tenant shall give Landlord written notice of Tenant's intention to perform work on the Premises at least twenty (20) days prior to the commencement of such work to enable Landlord to post and record a Notice of Nonresponsibility or other notice deemed proper before the commencement of any such work.

**14. Surrender of the Premises.** Upon the expiration or earlier termination of the Term, Tenant shall surrender the Premises to Landlord in its condition existing as of the Commencement Date, normal wear and tear and fire or other casualty excepted, with all interior walls repaired if damaged, all carpets shampooed and cleaned, all broken, marred or nonconforming acoustical ceiling tiles replaced, all windows washed, the plumbing and electric systems and lighting in good order and repair, including replacement of any burned out or broken light bulb or ballasts, and all floors cleaned and waxed, all to the reasonable satisfaction of Landlord. Tenant shall remove from the Premises all of Tenant's Alterations required to be removed pursuant to Paragraph 13 and all Tenant's Personal Property, and repair any damage and perform any restoration work caused by such removal. If Tenant fails to remove such Alterations and Tenant's Personal Property, and such failure continues after the termination of this Lease, Landlord may retain such property and all rights of Tenant with respect to it shall cease, or Landlord may place all or any portion of such property in public storage for Tenant's account. Tenant shall be liable to Landlord for costs of removal of any such Alterations and Tenant's Personal Property and storage and transportation costs of same, and the cost of repairing and restoring the Premises, together with interest at the Interest Rate from the date of expenditure by Landlord. If the Premises are not so surrendered at the termination of this Lease, Tenant shall indemnify Landlord and its Agents against all loss or liability, including attorneys' fees and costs, resulting from delay by Tenant in so surrendering the Premises.

Normal wear and tear, for the purposes of this Lease, shall be construed to mean wear and tear caused to the Premises by a natural aging process which occurs in spite of prudent application of the best standards for maintenance, repair, and janitorial practices. It is not intended, nor shall it be construed, to include items of neglected or deferred maintenance which would have or should have been attended to during the Term of the Lease if the best standards had been applied to properly maintain and keep the Premises at all times in good condition and repair.



## **15. Real Property Taxes.**

A. Payment by Tenant. On or before April 1 and December 1 of each calendar year during the Term, Tenant shall pay to Landlord, as Additional Rent, Tenant's Project Percentage of all Real Property Taxes as set forth on the County assessor's tax statement for the Project. Landlord shall give Tenant at least fifteen (15) days' prior written notice of the amount so due. Upon Landlord's receipt of the Real Property Tax payment from Tenant and other tenants of the Property, Landlord shall pay the taxes to the County. If Tenant fails to pay Tenant's Project Percentage of the Real Property Taxes on or before April 1 and December 1, respectively, Tenant shall pay to Landlord any penalty incurred by such late payment. Tenant shall pay Tenant's Project Percentage of any Real Property Tax not included within the County tax assessor's tax statement within thirty (30) days after being billed for same by Landlord. The foregoing dates are based on the dates established by the County as the dates on which Real Property Taxes become delinquent if not paid. If such delinquency dates change, the dates on which Tenant must pay Tenant's Project Percentage of such taxes shall be at least ten (10) days prior to the delinquency dates. Notwithstanding the foregoing, at any time, upon prior written notice to Tenant, Landlord shall have the right to require that Tenant pay one-twelfth (1/12th) of the Real Property Taxes payments to Landlord directly, on the first (1st) day of each calendar month. Assessments, taxes, fees, levies and charges may be imposed by governmental agencies for such purposes as fire protection, street, sidewalk, road, utility construction and maintenance, refuse removal and for other governmental services which may formerly have been provided without charge to property owners or occupants. It is the intention of the parties that all new and increased assessments, taxes, fees, levies and charges are to be included within the definition of Real Property Taxes for purposes of this Lease.

B. Taxes on Tenant Improvements and Personal Property. Tenant shall pay any increase in Real Property Taxes resulting from any and all Alterations and Tenant Improvements of any kind whatsoever placed in, on or about the Premises for the benefit of, at the request of, or by Tenant. Tenant shall pay prior to delinquency all taxes assessed or levied against Tenant's Personal Property in, on or about the Premises or elsewhere. When possible, Tenant shall cause its Personal Property to be assessed and billed separately from the real or personal property of Landlord.

C. Proration. Tenant's liability to pay Real Property Taxes shall be prorated on the basis of a 365-day year to account for any fractional portion of a fiscal tax year included at the commencement or expiration of the Term. With respect to any assessments which may be levied against or upon the Property, or which under the laws then in force may be evidenced by improvements or other bonds or may be paid in annual installments, only the amount of such annual installment (with appropriate proration for any partial year) and interest due thereon shall be included within the computation of the annual Real Property Taxes levied against the Premises.

**16. Utilities and Services.** Tenant shall be responsible for and shall pay promptly all charges for water, gas, electricity, telephone, refuse pickup, janitorial service and all other utilities, materials and services furnished directly to or used by Tenant in, on or about the Premises during the Term, together with any taxes thereon. If such utilities are not separately metered to the Premises, Landlord shall bill Tenant for Tenant's pro rata share based on Tenant's Building Percentage or other equitable basis as determined by Landlord. Landlord shall not be liable in damages or otherwise for any failure or interruption of any utility service or other service furnished to the Premises, except that resulting from the willful misconduct of Landlord.

**17. Repair and Maintenance.**

A. **Landlord's Obligations.** Landlord shall keep in good order, condition and repair, at Landlord's sole cost and expense, the roof membrane and the structural parts of the Building, which structural parts include only the foundation, subflooring, roof structure, exterior walls and exterior plumbing, except that any damage thereto caused by the negligence or willful misconduct of Tenant or Tenant's agents, employees or invitees, or by reason of the failure of Tenant to perform or comply with any terms of this Lease, or caused by Alterations made by Tenant or by Tenant's agents, employees or contractors, shall be repaired at Tenant's expense. Landlord shall also maintain in good order, condition and repair the Common Areas of the Building and the Outside Area of the Project and Tenant shall reimburse Landlord for the cost thereof as provided in Paragraphs 17.C and 17.D.

The manner in which the Common Area and the Outside Area shall be maintained and the expenditures therefor shall be at the sole discretion of Landlord. Landlord shall at all times have exclusive control of the Common Area and Outside Area and may at any time temporarily close any part thereof, exclude and restrain anyone from any part thereof, except the bona fide customers, employees and invitees of Tenant who use the Common Area and Outside Area in accordance with the rules and regulations as Landlord may from time to time promulgate, and may change the configuration or location of the Common Area and Outside Area. In exercising any such rights, Landlord shall make a reasonable effort to minimize any disruption of Tenant's business. Tenant waives the provisions of Sections 1941 and 1942 of the California Civil Code and any similar or successor law regarding Tenant's right to make repairs and deduct the expenses of such repairs from the Rent due under this Lease.

B. **Tenant's Obligations.** Tenant shall at all times and at its own expense clean, keep and maintain in good order, condition and repair every part of the Premises which is not within Landlord's obligation pursuant to Paragraph 17.A. Tenant's repair and maintenance obligations shall include, all plumbing and sewage facilities within the Premises, fixtures, interior walls and ceiling, floors, windows, doors, entrances, plateglass, showcases, skylights, all electrical facilities and equipment, including lighting fixtures, lamps, fans and any exhaust equipment and systems, any automatic fire extinguisher equipment within the Premises, electrical motors and all other appliances and equipment of every kind and nature located in, upon or about the Premises. Tenant shall also be responsible for all pest control within the Premises.

C. Tenant to Pay Expenses. Tenant shall pay, as Additional Rent, Tenant's Building Percentage of all reasonable costs and expenses paid or incurred by Landlord during the Term in operating, maintaining, repairing and replacing the Common Area (the "Common Area Expenses"), and Tenant's Project Percentage of all reasonable costs and expenses paid or incurred by Landlord in operating, maintaining, repairing and replacing the Outside Area (the "Outside Area Expenses"). The Common Area Expenses and Outside Area Expenses may include, as appropriate, the cost of labor, materials, supplies and services used or consumed in operating, maintaining, repairing and replacing the HVAC system, Common Area lighting, the Building elevator, if any, and the Outside Area, including landscaping and sprinkler systems, concrete walkways and paved parking areas; maintaining and repairing signs and site lighting; all utilities provided to the Building and the Outside Area; any alterations or improvements required by governmental authority to comply with applicable laws (excluding, however, any alterations or improvements required by the Americans with Disabilities Act); the cost of maintaining, repairing and replacing exterior windows; and a management fee. Any Common Area Expenses or Outside Area Expense that constitute capital expenditures shall be amortized over their useful life in accordance with generally accepted accounting principles.

D. Monthly Payments. From and after the Commencement Date, Tenant shall pay to Landlord on the first day of each calendar month of the Term an amount estimated by Landlord to be Tenant's Building Percentage of the monthly Common Area Expenses and Tenant's Project Percentage of the monthly Outside Area Expenses. The foregoing estimated monthly charges may be adjusted by Landlord at the end of any calendar quarter on the basis of Landlord's experience and reasonably anticipated costs. Any such adjustment shall be effective as of the calendar month next succeeding receipt by Tenant of written notice of such adjustment. Within one hundred twenty (120) days following the end of each calendar year Landlord shall furnish Tenant a statement of the actual Common Area Expenses and Outside Area Expenses ("Actual Expenses") for the calendar year and the payments made by Tenant with respect to such period. If Tenant's payments for the Common Area Expenses or the Outside Area Expenses, as the case may be, do not equal the amount of the Actual Expenses, Tenant shall pay Landlord the deficiency within ten (10) days after receipt of such statement. If Tenant's payments exceed the Actual Expenses, Landlord shall either offset the excess against the Common Area Expenses or Outside Area Expenses, as appropriate, next thereafter to become due to Landlord, or shall refund the amount of the overpayments to Tenant, in cash, as Landlord shall elect. There shall be appropriate adjustments of the Common Area Expenses and Outside Area Expenses as of the Commencement Date and expiration of the Term.

E. Compliance with Governmental Regulations. Tenant shall, at its cost, comply with all present and future regulations, rules, laws, ordinances, and requirements of all governmental authorities (including, without limitation state, municipal, County and federal governments and their departments, bureaus, boards and officials) arising from Tenant's use or occupancy of the Premises.

**18. Liens.** Tenant shall keep the Building and the Project free from any liens arising out of any work performed, materials furnished or obligations incurred by or on behalf of Tenant and hereby indemnifies and holds Landlord and its Agents harmless from all liability and cost, including attorneys' fees and costs, in connection with or arising out of any such lien or claim of lien. Tenant shall cause any such lien imposed to be released of record by payment or posting of a proper bond acceptable to Landlord within ten (10) days after written request by Landlord. Tenant shall give Landlord written notice of Tenant's intention to perform work on the Premises which might result in any claim of lien at least ten (10) days prior to the commencement of such work to enable Landlord to post and record a Notice of Nonresponsibility. If Tenant fails to so remove any such lien within the prescribed ten (10) day period, then Landlord may do so at Tenant's expense and Tenant shall reimburse Landlord for such amounts upon demand. Such reimbursement shall include all costs incurred by Landlord including Landlord's reasonable attorneys' fees with interest thereon at the Interest Rate.

**19. Landlord's Right to Enter the Premises.** Tenant shall permit Landlord and its Agents to enter the Premises at all reasonable times with reasonable notice, except for emergencies in which case no notice shall be required, to inspect the same, to post Notices of Nonresponsibility and similar notices, and "For Sale" signs, to show the Premises to interested parties such as prospective lenders and purchasers, to make necessary repairs, to discharge Tenant's obligations hereunder when Tenant has failed to do so within a reasonable time after written notice from Landlord, and at any reasonable time within one hundred and eighty (180) days prior to the expiration of the Term, to place upon the Building and the Outside Area ordinary "For Lease" signs and to show the Premises to prospective tenants. The above rights are subject to reasonable security regulations of Tenant, and to the requirement that Landlord shall at all times act in a manner to cause the least possible interference with Tenant's business.

**20. Signs.** Landlord shall provide Tenant space for Tenant's identification sign on an exterior monument sign in the Outside Area in common with other tenants of the Project and shall provide Tenant with Building-standard signage at the entrance to the Premises and a listing in the Building directory. Tenant shall have no right to maintain any Tenant identification sign in any other location in, on or about the Building or the Project, and shall not display or erect any other Tenant identification sign, display or other advertising material that is visible from the exterior of the Building. The size, design, color and other physical aspects of Tenant's monument signage shall be subject to Landlord's written approval prior to installation. Tenant shall pay all costs associated with Tenant's monument signage, including installation, maintenance, repair and removal. Upon the expiration or sooner termination of this Lease, Tenant shall remove its signage from the monument sign and repair any damage to the monument sign caused by the installation and/or removal of Tenant's sign. If Tenant fails to maintain its sign, or, if Tenant fails to remove its sign upon termination of this Lease and repair any damage to the monument sign as required herein, Landlord may do so at Tenant's expense.

## **21. Insurance.**

A. Indemnification. Tenant hereby agree to defend, indemnify and hold harmless Landlord and its Agents from and against any and all damage, loss, liability or expense including attorneys' fees and legal costs suffered directly or by reason of any claim, suit or judgment brought by or in favor of any person or persons for damage, loss or expense due to, but not limited to, bodily injury and property damage sustained by such person or persons which arises out of, is occasioned by or in any way attributable to the use or occupancy of the Premises or the Project or any part thereof and adjacent areas by Tenant, the acts or omissions of the Tenant, its agents, employees or any contractors brought onto the Premises or the Project by Tenant, except to the extent caused by the gross negligence or willful misconduct of Landlord or its Agents. Tenant agrees that the obligations assumed herein shall survive this Lease.

B. Tenant's Insurance. Tenant agrees to maintain in full force and effect at all times during the Term, at its own expense, for the protection of Tenant and Landlord, as their interests may appear, policies of insurance issued by a responsible carrier or carriers which afford the following coverages:

(i) Commercial general liability insurance in an amount not less than Two Million and no/100th Dollars (\$2,000,000.00) combined single limit for both bodily injury and property damage which includes blanket contractual liability broad form property damage, personal injury, completed operations, products liability, and fire damage legal (in an amount not less than Fifty Thousand Dollars (\$50,000)), naming Landlord and its Agents as additional insureds.

(ii) Special form property insurance (including, without limitation, vandalism, malicious mischief, inflation endorsement, and sprinkler leakage endorsement) on Tenant's Personal Property located on or in the Premises. Such insurance shall be in the full amount of the replacement cost, as the same may from time to time increase as a result of inflation or otherwise, and shall be in a form providing coverage comparable to the coverage provided in the standard ISO All-Risk form. As long as this Lease is in effect, the proceeds of such policy shall be used for the repair and replacement of such items so insured. Landlord shall have no interest in the insurance proceeds on Tenant's Personal Property.

(iii) Boiler and machinery insurance, including steam pipes, pressure pipes, condensation return pipes and other pressure vessels and HVAC equipment, including miscellaneous electrical apparatus, in an amount satisfactory to Landlord.

C. Premises Insurance. During the Term Landlord shall maintain special form property insurance (including inflation endorsement, sprinkler leakage endorsement, and, at Landlord's option, earthquake and flood coverage) on the Building and the Adjacent Building(s), excluding coverage of all Tenant's Personal Property located on or in the Premises, but including the Tenant Improvements, if any are provided for in Paragraph 9 of this Lease. Such insurance shall also include insurance against loss of rents, including, at Landlord's option, earthquake and flood, in an amount equal to the Monthly Rent and Additional Rent, and any other sums payable under the Lease, for a period of at least twelve (12) months commencing on the date of loss. Such insurance shall name Landlord and its Agents as named insureds and include a lender's loss payable endorsement in favor of Landlord's lender (Form 438 BFU Endorsement). Tenant shall reimburse Landlord for Tenant's Project Percentage of Landlord's annual cost of such insurance as Additional Rent, monthly on the first day of each calendar month of the Term, prorated for any partial month, or on such other periodic basis as Landlord shall elect. If the Project insurance premiums are increased after the Commencement Date, due to an increase in the value of the Building or the Adjacent Building(s) or their replacement cost, Tenant shall pay Tenant's Percentage of such increase within ten (10) days of notice of such increase. If such insurance premiums are increased due to Tenant's use of the Premises, improvements installed by Tenant, or any other cause solely attributable to Tenant, Tenant shall be required to pay the full amount of the increase.

D. Increased Coverage. Upon demand, Tenant shall provide Landlord, at Tenant's expense, with such increased amount of existing insurance, and such other insurance as Landlord or Landlord's lender may reasonably require to afford Landlord and Landlord's lender adequate protection.

E. Co-Insurer. If, on account of the failure of Tenant to comply with the foregoing provisions, Landlord is adjudged a co-insurer by its insurance carrier, then, any loss or damage, Landlord shall sustain by reason thereof, including attorneys' fees and costs, shall be borne by Tenant and shall be immediately paid by Tenant upon receipt of a bill therefor and evidence of such loss.

F. **Insurance Requirements.** All insurance shall be in a form satisfactory to Landlord and shall be carried with companies that have a general policy holder's rating of not less than "A" and a financial rating of not less than Class "X" in the most current edition of Best's Insurance Reports; shall provide that such policies shall not be subject to material alteration or cancellation except after at least thirty (30) days' prior written notice to Landlord; and shall be primary as to Landlord. The policy or policies, or duly executed certificates for them, together with satisfactory evidence of payment of the premium thereon shall be deposited with Landlord prior to the Commencement Date, and upon renewal of such policies, not less than thirty (30) days prior to the expiration of the term of such coverage. If Tenant fails to procure and maintain the insurance required hereunder, Landlord may, but shall not be required to, order such insurance at Tenant's expense and Tenant shall reimburse Landlord. Such reimbursement shall include all costs incurred by Landlord including Landlord's reasonable attorneys' fees, with interest thereon at the Interest Rate.

G. **Landlord's Disclaimer.** Landlord and its Agents shall not be liable for any loss or damage to persons or property resulting from fire, explosion, falling plaster, glass, tile or sheetrock, steam, gas, electricity, water or rain which may leak from any part of the Building, or from the pipes, appliances or plumbing works therein or from the roof, street or subsurface, or from any cause whatsoever, unless caused by or due to the sole negligence or willful acts of Landlord. Landlord and its Agents shall not be liable for any latent defect in the Premises. Tenant shall give prompt written notice to Landlord in case of a casualty, accident or repair needed in the Premises.

22. **Waiver of Subrogation.** Landlord and Tenant each hereby waive all rights of recovery against the other on account of loss or damage occasioned to such waiving party for its property or the property of others under its control to the extent that such loss or damage is insured against under any property policy then in effect or would be insured against under a standard ISO special form causes of loss, CP 0030, policy of insurance. Tenant and Landlord shall, upon obtaining policies of insurance required hereunder, give notice to the insurance carrier that the foregoing mutual waiver of subrogation is contained in this Lease and Tenant and Landlord shall cause each insurance policy obtained by such party to provide that the insurance company waives all right of recovery by way of subrogation against either Landlord or Tenant in connection with any damage covered by such policy.

23. **Damage or Destruction.**

A. **Landlord's Obligation to Rebuild.** If the Premises or the Building is damaged or destroyed, Landlord shall promptly and diligently repair the same unless it has the right to terminate this Lease as provided herein and it elects to so terminate.

B. Right to Terminate. Landlord shall have the right to terminate this Lease in the event any of the following events occur:

(i) Insurance proceeds together with such sums which Tenant may in its sole discretion elect to contribute toward the cost of such repair are not available to pay one hundred percent (100%) of the cost of such repair; excluding Tenant's pro rata share of the deductible for which Tenant shall be responsible;

(ii) The Premises or the Building cannot, with reasonable diligence, be fully repaired by Landlord within one hundred eighty (180) days after the date of the damage or destruction; or

(iii) The Premises or Building cannot be safely repaired because of the presence of hazardous factors, including, but not limited to, earthquake faults, radiation, chemical waste and other similar dangers.

If Landlord elects to terminate this Lease, Landlord may give Tenant written notice of its election to terminate within thirty (30) days after such damage or destruction, and this Lease shall terminate fifteen (15) days after the date Tenant receives such notice. If Landlord elects not to terminate the Lease, Landlord shall promptly, following the date of such damage or destruction, commence the process of obtaining necessary permits and approvals, and shall commence repair of the Premises or the Building as soon as practicable and thereafter prosecute the same diligently to completion, in which event this Lease will continue in full force and effect. All insurance proceeds from insurance under Paragraph 21., excluding proceeds for Tenant's Personal Property, shall be disbursed and paid to Landlord. Tenant shall be required to pay to Landlord the amount of any deductibles payable in connection with any insured casualties, unless the casualty was caused by the sole negligence or willful misconduct of Landlord.

C. Limited Obligation to Repair. Landlord's obligation, should it elect or be obligated to repair or rebuild, shall be limited to the basic Premises, the Tenant Improvements, or the basic Building, as the case may be.

D. Abatement of Rent. Rent shall be temporarily abated proportionately during any period when, by reason of such damage or destruction, Landlord reasonably determines that there is substantial interference with Tenant's use of the Premises, having regard to the extent to which Tenant may be required to discontinue Tenant's use of the Premises. Such abatement shall commence upon such damage or destruction and end upon substantial completion by Landlord of the repair or reconstruction which Landlord is obligated or undertakes to do. Tenant shall not be entitled to any compensation or damages from Landlord for loss of the use of the Premises, damage to Tenant's Personal Property or any inconvenience occasioned by such damage, repair or restoration. Tenant hereby waives the provisions of Section 1932, Subdivision 2, and Section 1933, Subdivision 4, of the California Civil Code, and the provisions of any similar law hereinafter enacted.



E. Damage Near End of Term. Anything herein to the contrary notwithstanding, if the Premises or the Building is destroyed or damaged during the last twelve (12) months of the Term, then Landlord may, at its option, cancel and terminate this Lease as of the date of the occurrence of such damage. If Landlord does not elect to so terminate this Lease, the repair of such damage shall be governed by Paragraphs 23.A. and 23.B.

**24. Condemnation**. If title to all of the Premises or Building or so much thereof is taken for any public or quasi-public use under any statute or by right of eminent domain so that reconstruction of the Premises or Building will not, in Landlord's and Tenant's mutual opinion, result in the Premises being reasonably suitable for Tenant's continued occupancy for the uses and purposes permitted by this Lease, this Lease shall terminate as of the date that possession of the Premises or Building or part thereof be taken. A sale by Landlord to any authority having the power of eminent domain, either under threat of condemnation or while condemnation proceedings are pending, shall be deemed a taking under the power of eminent domain for all purposes of this paragraph.

If any part of the Premises or Building is taken and the remaining part is reasonably suitable for Tenant's continued occupancy for the purposes and uses permitted by this Lease, this Lease shall, as to the part so taken, terminate as of the date that possession of such part of the Premises or Building is taken. The Rent and other sums payable hereunder shall be reduced in the same proportion that Tenant's use and occupancy of the Premises is reduced. If any portion of the Common Area or Outside Area is taken, Tenant's Rent shall be reduced only if such taking materially interferes with Tenant's use of the Common Area or Outside Area and then only to the extent that the fair market rental value is diminished by such partial taking. If the parties disagree as to the amount of Rent reduction, the matter shall be resolved by arbitration and such arbitration shall comply with and be governed by the California Arbitration Act, Sections 1280 through 1294.2 of the California Code of Civil Procedure. Each party hereby waives the provisions of Section 1265.130 of the California Code of Civil Procedure allowing either party to petition the Superior Court to terminate this Lease in the event of a partial taking of the Property or Premises.

No award for any partial or entire taking shall be apportioned. Tenant assigns to Landlord its interest in any award which may be made in such taking or condemnation, together with any and all rights of Tenant arising in or to the same or any part thereof. Nothing contained herein shall be deemed to give Landlord any interest in or require Tenant to assign to Landlord any separate award made to Tenant for the taking of Tenant's Personal Property, for the interruption of Tenant's business, or its moving costs, or for the loss of its good will.

## **25. Assignment and Subletting.**

A. Landlord's Consent. Tenant shall not enter into a Sublet without Landlord's prior written consent, which consent shall not be unreasonably withheld. Any attempted or purported Sublet without Landlord's prior written consent shall be void and confer no rights upon any third person and, at Landlord's election, shall terminate this Lease. Each subtenant shall agree in writing, for the benefit of Landlord, to assume, to be bound by, and to perform the terms, conditions and covenants of this Lease to be performed by Tenant. Notwithstanding anything contained herein, Tenant shall not be released from personal liability for the performance of each term, condition and covenant of this Lease by reason of Landlord's consent to a Sublet unless Landlord specifically grants such release in writing.

B. Information to be Furnished. If Tenant desires at any time to Sublet the Premises or any portion thereof, it shall first notify Landlord of its desire to do so and shall submit in writing to Landlord: (i) the name of the proposed Subtenant; (ii) the nature of the proposed Subtenant's business to be carried on in the Premises; (iii) the terms and provisions of the proposed Sublet and a copy of the proposed Sublet form containing a description of the subject premises; and (iv) such financial information, including financial statements, as Landlord may reasonably request concerning the proposed Subtenant.

C. Landlord's Alternatives. Within five (5) days after Landlord's receipt of the information specified in Paragraph 25.B., Landlord shall, by written notice to Tenant, elect: (i) to consent to the Sublet by Tenant; (ii) to refuse its consent to the Sublet, or (iii) to terminate this Lease. If Landlord consents to the Sublet, Tenant may thereafter enter into a valid Sublet of the Premises or portion thereof, upon the terms and conditions and with the proposed Subtenant set forth in the information furnished by Tenant to Landlord pursuant to Paragraph 25.B., subject, however, at Landlord's election, to the condition that any excess of the Subrent over the Rent required to be paid by Tenant under this Lease less reasonable attorneys' fees, brokerage commissions, and tenant improvement costs paid by Tenant in connection with the Sublet, shall be paid to Landlord.

D. Exempt Sublets. Notwithstanding the above, Landlord's prior written consent shall not be required for a Sublet to (i) an entity that controls, is controlled by, or is under common control with, Tenant, or (ii) an entity resulting from a merger with, consolidation or other corporate reorganization of Tenant, if Tenant gives Landlord prior written notice of the name of any such Subtenant and, in the event of an assignment, the assignee assumes, in writing, for the benefit of Landlord all of Tenant's obligations under this Lease. An assignment or other transfer of this Lease to a purchaser of all or substantially all of the assets of Tenant shall be deemed a Sublet requiring Landlord's prior written consent.

**26. Default.**

A. Tenant's Default. A default under this Lease by Tenant shall exist if any of the following occurs:

(i) If Tenant fails to pay Rent or any other sum required to be paid hereunder when due; or

(ii) If Tenant fails to perform any term, covenant or condition of this Lease except those requiring the payment of money, and Tenant fails to cure such breach within twenty (20) days after written notice from Landlord where such breach could reasonably be cured within such twenty (20) day period; provided, however, that where such failure could not reasonably be cured within the twenty (20) day period; that Tenant shall not be in default if it commences such performance within the twenty (20) day period and diligently thereafter prosecutes the same to completion; or

(iii) If Tenant assigns its assets for the benefit of its creditors; or

(iv) If the sequestration or attachment of or execution on any material part of Tenant's Personal Property essential to the conduct of Tenant's business occurs, and Tenant fails to obtain a return or release of such Personal Property within thirty (30) days thereafter, or prior to sale pursuant to such sequestration, attachment or levy, whichever is earlier; or

(v) If a court makes or enters any decree or order other than under the bankruptcy laws of the United States adjudging Tenant to be insolvent; or approving as properly filed a petition seeking reorganization of Tenant; or directing the winding up or liquidation of Tenant and such decree or order shall have continued for a period of thirty (30) days.

B. Remedies. Upon a default, Landlord shall have the following remedies, in addition to all other rights and remedies provided by law or otherwise provided in this Lease, to which Landlord may resort cumulatively or in the alternative:

(i) Landlord may continue this Lease in full force and effect, and this Lease shall continue in full force and effect as long as Landlord does not terminate this Lease, and Landlord shall have the right to collect Rent when due.

(ii) Landlord may terminate Tenant's right to possession of the Premises at any time by giving written notice to that effect, and relet the Premises or any part thereof. Tenant shall be liable immediately to Landlord for all costs Landlord incurs in reletting the Premises or any part thereof, including, without limitation, broker's commissions, expenses of cleaning and redecorating the Premises required by the reletting and like costs. Reletting may be for a period shorter or longer than the remaining term of this Lease. No act by Landlord other than giving written notice to Tenant shall terminate this Lease. Acts of maintenance, efforts to relet the Premises or the appointment of a receiver on Landlord's initiative to protect Landlord's interest under this Lease shall not constitute a termination of Tenant's right to possession. On termination, Landlord has the right to remove all Tenant's Personal Property and store same at Tenant's cost and to recover from Tenant as damages:

(a) The worth at the time of award of unpaid Rent and other sums due and payable which had been earned at the time of termination; plus

(b) The worth at the time of award of the amount by which the unpaid Rent and other sums due and payable which would have been payable after termination until the time of award exceeds the amount of such Rent loss that Tenant proves could have been reasonably avoided; plus

(c) The worth at the time of award of the amount by which the unpaid Rent and other sums due and payable for the balance of the Term after the time of award exceeds the amount of such Rent loss that Tenant proves could be reasonably avoided; plus

(d) Any other amount necessary which is to compensate Landlord for all the detriment proximately caused by Tenant's failure to perform Tenant's obligations under this Lease, or which, in the ordinary course of things, would be likely to result therefrom, including, without limitation, and costs or expenses incurred by Landlord: (i) in retaking possession of the Premises; (ii) in maintaining, repairing, preserving, restoring, replacing, cleaning, altering or rehabilitating the Premises or any portion thereof, including such acts for reletting to a new tenant or tenants; (iii) for leasing commissions; or (iv) for any other costs necessary or appropriate to relet the Premises; plus

(e) At Landlord's election, such other amounts in addition to or in lieu of the foregoing as may be permitted from time to time by the laws of the State of California.

The “worth at the time of award” of the amounts referred to in Paragraphs 26.B(ii)(a) and 26.B(ii)(b) is computed by allowing interest at the Interest Rate on the unpaid rent and other sums due and payable from the termination date through the date of award. The “worth at the time of award” of the amount referred to in Paragraph 26.B(ii)(c) is computed by discounting such amount at the discount rate of the Federal Reserve Bank of San Francisco at the time of award plus one percent (1%). Tenant waives redemption or relief from forfeiture under California Code of Civil Procedure Sections 1174 and 1179, or under any other present or future law, in the event Tenant is evicted or Landlord takes possession of the Premises by reason of any default of Tenant hereunder.

(iii) Landlord may, with or without terminating this Lease, re-enter the Premises and remove all persons and property from the Premises; such property may be removed and stored in a public warehouse or elsewhere at the cost of and for the account of Tenant. No re-entry or taking possession of the Premises by Landlord pursuant to this paragraph shall be construed as an election to terminate this Lease unless a written notice of such intention is given to Tenant.

C. **Landlord’s Default.** Landlord shall not be deemed to be in default in the performance of any obligation required to be performed by it hereunder unless and until it has failed to perform such obligation within thirty (30) days after receipt of written notice by Tenant to Landlord specifying the nature of such default; provided, however, that if the nature of Landlord’s obligation is such that more than thirty (30) days are required for its performance, then Landlord shall not be deemed to be in default if it shall commence such performance within such thirty (30) day period and thereafter diligently prosecute the same to completion.

**27. Subordination.** This Lease is subject and subordinate to ground and underlying leases, mortgages and deeds of trust (collectively “Encumbrances”) which may now or hereafter affect the Building or the Project, provided, however, if the holder or holders of any such Encumbrance (“Holder”) shall require that this Lease to be prior and superior thereto, within seven (7) days of written request of Landlord to Tenant, Tenant shall execute, have acknowledged and deliver any and all documents or instruments, in the form presented to Tenant, which Landlord or Holder deems necessary or desirable for such purposes. Landlord shall have the right to cause this Lease to be and become and remain subject and subordinate to any and all Encumbrances which are now or may hereafter be executed covering the Premises or any renewals, modifications, consolidations, replacements or extensions thereof, for the full amount of all advances made or to be made thereunder and without regard to the time or character of such advances, together with interest thereon and subject to all the terms and provisions thereof; provided only, that in the event of termination of any such lease or upon the foreclosure of any such mortgage or deed of trust, so long as Tenant is not in default, Holder agrees to recognize Tenant’s rights under this Lease as long as Tenant shall pay the Rent and observe and perform all the provisions of this Lease to be observed and performed by Tenant. Within ten (10) days after Landlord’s written request, Tenant shall execute any and all documents required by Landlord or the Holder required to make this Lease subordinate to any lien of the Encumbrance. If Tenant fails to do so, it shall be deemed that this Lease is subordinated.

Notwithstanding anything to the contrary set forth in this paragraph, Tenant hereby attorns and agrees to attorn to any entity purchasing or otherwise acquiring the Building or the Project at any sale or other proceeding or pursuant to the exercise of any other rights, powers or remedies under such Encumbrance.

**28. Estoppel Certificates.** Tenant shall within seven (7) days following written request by Landlord,

(i) Execute and deliver to Landlord any documents, including estoppel certificates, in the form prepared by Landlord (a) certifying that this Lease is unmodified and in full force and effect or, if modified, stating the nature of such modification and certifying that this Lease, as so modified, is in full force and effect and the date to which the Rent and other charges are paid in advance, if any; (b) acknowledging that there are not, to Tenant's knowledge, any uncured defaults on the part of Landlord, or, if there are uncured defaults on the part of the Landlord, stating the nature of such uncured defaults; and (c) evidencing the status of the Lease as may be required either by a lender making a loan to Landlord to be secured by deed of trust or mortgage covering the Building or the Project or a purchaser of the Building or the Project from Landlord. Tenant's failure to deliver an estoppel certificate within seven (7) days after delivery of Landlord's written request therefor shall be conclusive upon Tenant (a) that this Lease is in full force and effect, without modification except as may be represented by Landlord (b) that there are now no uncured defaults in Landlord's performance and (c) that no Rent has been paid in advance.

(ii) Deliver to Landlord the current financial statements of Tenant, and financial statements of the two (2) years prior to the current financial statements year, with an opinion of a certified public accountant, including a balance sheet and profit and loss statement for the most recent prior year, all prepared in accordance with generally accepted accounting principles consistently applied.

**29. Transfer of the Building or the Project by Landlord.** In the event of any conveyance of the Building or the Project and assignment by Landlord of this Lease, Landlord shall be and is hereby entirely released from all liability under any and all of its covenants and obligations contained in or derived from this Lease occurring after the date of such conveyance and assignment and Tenant agrees to attorn to such transferee provided such transferee assumes Landlord's obligations under this Lease.

**30. Landlord's Right to Perform Tenant's Covenants.** If Tenant shall at any time fail to make any payment or perform any other act on its part to be made or performed under this Lease, Landlord may, but shall not be obligated to and without waiving or releasing Tenant from any obligation of Tenant under this Lease, make such payment or perform such other act to the extent Landlord may deem desirable, and in connection therewith, pay expenses and employ counsel. All sums so paid by Landlord and all penalties, interest and costs in connection therewith shall be due and payable by Tenant on the next day after any such payment by Landlord, together with interest thereon at the Interest Rate from such date to the date of payment by Tenant to Landlord, plus collection costs and attorneys' fees. Landlord shall have the same rights and remedies for the nonpayment thereof as in the case of default in the payment of Rent.

**31. Tenant's Remedy.** If, as a consequence of a default by Landlord under this Lease, Tenant recovers a money judgment against Landlord, such judgment shall be satisfied only out of the proceeds of sale received upon execution of such judgment and levied thereon against the right, title and interest of Landlord in the Building and out of Rent or other income from such property receivable by Landlord or out of consideration received by Landlord from the sale or other disposition of all or any part of Landlord's right, title or interest in the Building, and neither Landlord nor its agents shall be liable for any deficiency.

**32. Mortgagee Protection.** If Landlord defaults under this Lease, Tenant will notify any beneficiary of a deed of trust or mortgagee of a mortgage covering the Building or the Project, and offer such beneficiary or mortgagee a reasonable opportunity to cure the default, including time to obtain possession of the Building or the Project by power of sale or a judicial foreclosure, if such should prove necessary to effect a cure.

**33. Brokers.** Tenant and Landlord warrants and represents that it has had no dealings with any real estate broker or agent in connection with the negotiation of this Lease other than JR Parrish, and that it knows of no other real estate broker or agent who is or might be entitled to a commission in connection with this Lease. Tenant agrees to indemnify, defend and hold Landlord and its Agents harmless from and against any and all liabilities or expenses, including attorneys' fees and costs, arising out of or in connection with claims made by any other broker or individual for commissions or fees resulting from Tenant's execution of this Lease.

**34. Modifications for Lender.** If, in connection with obtaining financing for the Building or the Project or any portion thereof, Landlord's lender shall request reasonable modification to this Lease as a condition to such financing, Tenant shall not unreasonably withhold, delay or defer its consent thereto, provided such modifications do not materially adversely affect Tenant's rights hereunder.

**35. Parking.** Tenant shall have the right to use its pro rata share of the Project's parking facilities in common with other tenants of the Project upon terms and conditions, as may from time to time be established by Landlord. Tenant agrees not to overburden the parking facilities and agrees to cooperate with Landlord and other tenants in the use of the parking facilities. Landlord reserves the right in its discretion to determine whether the parking facilities are becoming crowded and to allocate and assign parking spaces among Tenant and the other tenants.

**36. General.**

A. Notices. Any notice or demand required or desired to be given under this Lease shall be in writing and shall be personally served or in lieu of personal service may be given by mail. If given by mail, such notice shall be deemed to have been given when seventy-two (72) hours have elapsed from the time when such notice was deposited in the United States mail, registered or certified, and postage prepaid, addressed to the party to be served. At the date of execution of this Lease, the addresses of Landlord and Tenant are as set forth in Paragraph 1. After the Commencement Date, the address of Tenant shall be the address of the Premises. All notices shall be served to both the Premises and the address set forth in Paragraph 1. Either party may change its address by giving notice of same in accordance with this paragraph.

B. Attorneys' Fees. If either party brings any action or legal proceeding for damages for an alleged breach of any provision of this Lease, to recover rent, or other sums due, to terminate the tenancy of the Premises or to enforce, protect or establish any term, condition or covenant of this Lease or right of either party, the prevailing party shall be entitled to recover as a part of such action or proceedings, or in a separate action brought for that purpose, reasonable attorneys' fees and costs.

C. Acceptance. This Lease shall only become effective and binding upon full execution hereof by Landlord and delivery of a signed copy to Tenant. Neither party shall record this Lease nor a short form memorandum thereof.

D. Captions. The captions and headings used in this Lease are for the purpose of convenience only and shall not be construed to limit or extend the meaning of any part of this Lease.

E. Executed Copy. Any fully executed copy of this Lease shall be deemed an original for all purposes.

F. Time. Time is of the essence for the performance of each term, condition and covenant of this Lease.



G. Separability. If one or more of the provisions contained herein, except for the payment of Rent, is for any reason held invalid, illegal or unenforceable in any respect, such invalidity, illegality, or unenforceability shall not affect any other provisions of this Lease, but this Lease shall be construed as if such invalid, illegal or unenforceable provision had not been contained herein.

H. Choice of Law. This Lease shall be construed and enforced in accordance with the laws of the State of California. The language in all parts of this Lease shall in all cases be construed as a whole according to its fair meaning and not strictly for or against either Landlord or Tenant.

I. Gender: Singular, Plural. When the context of this Lease requires, the neuter gender includes the masculine, the feminine, a partnership or corporation or joint venture, and the singular includes the plural.

J. Binding Effect. The covenants and agreement contained in this Lease shall be binding on the parties hereto and on their respective successors and assigns to the extent this Lease is assignable.

K. Waiver. The waiver by Landlord of any breach of any term, condition or covenant, of this Lease shall not be deemed to be a waiver of such provision or any subsequent breach of the same or any other term, condition or covenant of this Lease. The subsequent acceptance of Rent hereunder by Landlord shall not be deemed to be a waiver of any preceding breach at the time of acceptance of such payment. No covenant, term or condition of this Lease shall be deemed to have been waived by Landlord unless such waiver is in writing signed by Landlord.

L. Entire Agreement. This Lease is the entire agreement between the parties, and there are no agreements or representations between the parties except as expressed herein. Except as otherwise provided herein, no subsequent change or addition to this Lease shall be binding unless in writing and signed by the parties hereto.

M. Authority. If Tenant is a corporation or a partnership, each individual executing this Lease on behalf of said corporation or partnership, as the case may be, represents and warrants that he is duly authorized to execute and deliver this Lease on behalf of said entity in accordance with its corporate bylaws, statement of partnership or certificate of limited partnership, as the case may be, and that this Lease is binding upon said entity in accordance with its terms. Landlord, at its option, may require a copy of such written authorization to enter into this Lease.

N. Exhibits. All exhibits, amendments, riders and addenda attached hereto are hereby incorporated herein and made a part hereof.

O. Lease Summary. The Lease Summary attached to this Lease is intended to provide general information only. In the event of any inconsistency between the Lease Summary and the specific provisions of this Lease, the specific provisions of this Lease shall prevail.

THIS LEASE is effective as of the date the last signatory necessary to execute the Lease shall have executed this Lease:

**TENANT:**

VimnetX Inc., a Delaware corporation

By: /s/ Kendall Larsen  
Its: CEO

Date: 3/21/06

**LANDLORD:**

GRANITE CREEK BUSINESS CENTER, a  
California general partnership

TBI-SV III, a California limited Partnership,  
General Partner

By: /s/ Charles J. Toeniskoetter  
Charles J. Toeniskoetter, Trustee of the  
Toniskoetter Faimly Trust dated December 19, 2001

Westwood Company — Scotts  
Valley, a California general partnership,  
General Partner

By: /s/ Anthony C. Morici  
Anthony C. Morici, Trustee of the  
Morici Separate Property Trust dated  
June 3, 1983

Date: 3/23/06

LEASE SUMMARY

LEASE DATE:	March 15, 2006
LANDLORD:	Granite Creek Business Center
LANDLORD'S ADDRESS:	c/o Toeniskoetter & Breeding, Inc., Development, 1960 The Alameda, San Jose, CA 95126
TENANT:	VirnetX Inc., a Delaware corporation
TENANT'S ADDRESS:	157 Provincetown Ct., Aptos, CA 95003
CONTACT PERSON/TELEPHONE #:	Kendall Larsen (650) 642-4838
PREMISES:	approximately 995 rentable square feet
BUILDING ADDRESS:	5615 Scotts Valley Drive, Scotts Valley, Ca. 95066
BUILDING SQUARE FOOTAGE:	approximately 38,000 rentable square feet
PROJECT SQUARE FOOTAGE:	approximately 90,000 rentable square feet
TENANT'S BUILDING PERCENTAGE:	3.11%
TENANT'S PROJECT PERCENTAGE:	1.11%
ANTICIPATED COMMENCEMENT DATE:	April 1, 2006
LEASE TERM:	Twelve (12) months
INITIAL MONTHLY RENT:	\$1,144.25/ MONTH, NNN
SECURITY DEPOSIT:	\$1,248.75

**GRANITE CREEK BUSINESS CENTER**  
Scotts Valley, California

FIRST AMENDMENT TO LEASE

THIS FIRST AMENDMENT TO LEASE ("First Amendment") is entered into as of April 1, 2007, by and between Granite Creek Business Center, a California general partnership ("Landlord") and VirnetX Inc., a Delaware Corporation ("Tenant") and is an Amendment to the Lease Agreement dated March 15, 2006 ("Lease"), relating to the Premises consisting of approximately nine hundred ninety-five (995) rentable square feet, as shown on EXHIBIT A of the Lease (the "Premises") in that certain building, commonly known as 5615 Scotts Valley Drive, Scotts Valley, CA 95066 (the "Building")

The parties now desire to amend the Lease as follows:

1. **LEASE TERM.** Paragraph 4.A. of the Lease is amended to provide the termination date to be March 31, 2008.
2. **RENT.** Paragraph 5.A. of the Lease is amended to reflect the following monthly rent schedule (NNN):

<u>Months of Term</u>	<u>Monthly Rent (NNN)</u>
April 1, 2007 – March 31, 2008	\$1,243.75 per month

Except as specifically amended herein, the Lease dated March 15, 2006 is hereby ratified and affirmed.

LANDLORD

TENANT

GRANITE CREEK BUSINESS CENTER  
A CALIFORNIA GENERAL PARTNERSHIP

VIRNETX, INC.

By /s/ Brad Krouskup  
Its Member  
Date 4/23/07

By /s/ Kendall Larsen  
Its President  
Date 4/17/07

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SECOND AMENDMENT TO LEASE

This Second Amendment to Lease ("Second Amendment"), dated as of April \_\_, 2008, is entered into by and between Granite Creek Business Center, a California general partnership ("Landlord"), and VimetX, Inc., a Delaware corporation ("Tenant").

RECITALS

A. Landlord and Tenant entered into that certain Lease dated March 15, 2006, and amended by a First Amendment to Lease dated April 1, 2007 (collectively, the "Lease") for the premises located at 5615 Scotts Valley Drive, Scotts Valley, California, currently consisting of approximately nine hundred ninety-five (995) rentable square feet.

B. The Term of the Lease is scheduled to expire on March 31, 2008.

C. Landlord and Tenant now desire to extend the Term of the Lease and to relocate Tenant to a larger suite within the Building, all on the terms and conditions set forth herein. The parties have agreed that all existing terms of the Lease shall remain in effect until June 1, 2008 (the date that Tenant shall be relocated to the new Premises), and thereafter the terms of the Lease shall be modified as provided in this Second Amendment.

AGREEMENT

In consideration of the mutual covenants set forth herein and other valuable consideration, Landlord and Tenant agree to amend the Lease as follows:

1. Premises. Paragraph 2 of the Lease is hereby amended to provide that, as of June 1, 2008, the Premises shall consist of the approximately three thousand eight hundred seventy-two (3,872) rentable square feet shown on Exhibit A attached hereto and commonly known as Suite 140. Tenant shall surrender possession of its existing premises, known as Suite 110, on May 31, 2008 in accordance with the provisions of paragraph 14 of the Lease.

2. Term. Paragraph 4.A. of the Lease is hereby amended to extend the Term for a period of four (4) years and three (3) months, so that the Term shall now expire on June 30, 2012, subject to further extension as provided in paragraph 11 below.

3. Rent. Paragraph 5.A. of the Lease is hereby amended to provide that, commencing June 1, 2008, the Monthly Rent shall be paid in accordance with the following schedule:

<u>Months of Term</u>	<u>Monthly Rent</u>
Jun 1, 2008 – Jun 30, 2008	\$0.00/month
Jul 1, 2008 – Jun 30, 2009	\$3,136.32/month
Jul 1, 2009 – Jun 30, 2010	\$4,259.20/month
Jul 1, 2010 – Jun 30, 2011	\$4,840.00/month
Jul 1, 2011 – Jun 30, 2012	\$5,033.60/month

4. Tenant's Percentage. Paragraph 3.S. of the Lease is hereby amended to provide that, as of June 1, 2008, Tenant's Building Percentage shall be increased to 12.10% and Tenant's Project Percentage shall be increased to 4.30%.

5. Security Deposit. Paragraph 7 of the Lease is hereby amended to provide that the Security Deposit shall be increased to \$5,033.60. Upon execution of this Second Amendment, Tenant shall deposit with Landlord the sum of \$3,784.94 to increase the existing Security Deposit to such required amount.

6. Tenant Improvements. Paragraph 9 of the Lease is hereby amended to provide that Landlord shall complete the following improvements to the Premises at Landlord's sole cost and expense: (i) construct a conference room with a glass side-light approximately 10 feet wide adjacent to the entry door, and one (1) private office at the locations shown on Exhibit B attached hereto, using Building-standard materials and finishes, and (ii) install locks on entry doors to all interior offices (collectively, the "Tenant Improvements").

7. Expenses. Paragraph 17.C. of the Lease is hereby amended to provide that Common Area Expenses shall not include any capital expenditures by Landlord for the remodeling of the Building lobby and other portions of the Common Area; provided, however, that the foregoing is not intended to cover, and shall not be deemed to cover, an alterations to the Common Area that may be required to comply with applicable laws. Paragraph 17.D. of the Lease is hereby amended to provide that, commencing with the Common Area Expenses and Outside Area Expenses payable by Tenant for the 2009 calendar year, the Actual Expenses to be paid by Tenant (calculated on a per rentable square foot basis) shall not increase by more than three percent (3%) over the Actual Expenses paid by Tenant for the prior calendar year (calculated on a per rentable square foot basis). For example, if the Actual Expenses paid by Tenant for the 2008 calendar year were \$0.66 per rentable square foot per month, then the Actual Expenses to be paid by Tenant for the 2009 calendar would not be more than \$0.68 per rentable square foot per month.

8. Indemnification . The first sentence in paragraph 21.A. of the Lease is hereby deleted and replaced with the following:

Tenant hereby agree to defend, indemnify and hold harmless Landlord and its Agents from and against any and all damage, loss, liability or expense including attorneys' fees and legal costs suffered directly or by reason of any claim, suit or judgment brought by or in favor of any person or persons for damage, loss or expense due to, but not limited to, bodily injury and property damage sustained by such person or persons which arises out of, is occasioned by or in any way attributable to the use or occupancy of the Premises or the Project or any part thereof and adjacent areas by Tenant, the acts or omissions of the Tenant, its agents, employees or any contractors brought onto the Premises or the Project by Tenant, except to the extent caused by the gross negligence or willful misconduct of Landlord or its Agents or by Landlord's breach of its obligations under this Lease.

9. Damage or Destruction. Paragraph 23.B. of the Lease is hereby amended to add the following sentences at the end of the paragraph:

Tenant shall have the right to terminate this Lease if the Premises or the Building cannot, with reasonable diligence, be fully restored within one hundred eighty (180) days after the date of the damage or destruction. If Tenant elects to terminate this Lease, Tenant shall give Landlord written notice of its election to terminate within thirty (30) days after such damage or destruction.

10. Default. Paragraphs 26.A.(iv) and (v) of the Lease are hereby amended to increase the 30-day period set forth therein to 90 days.

11. Option to Extend. The Lease is hereby amended to add the following provisions as Paragraph 37:

37. Option to Extend.

A. Option Period. Provided that Tenant is not in default under this Lease either at the time of exercise or at the time the extended Term commences, Tenant shall have the option to extend the Term of this Lease for one (1) additional period of three (3) years ("Option Period") on the same terms, covenants and conditions provided herein, except that upon such renewal (1) the Monthly Rent due hereunder shall be the greater of (a) the then fair market rental value of the Premises, and (b) \$1.30 per square foot per month, and (2) the limitation on increases in Common Area Expenses and Outside Area Expenses payable by Tenant shall no longer be applicable. Tenant shall exercise its option by giving Landlord written notice ("Option Notice") at least one hundred eighty (180) days, but not more than two hundred seventy (270) days, prior to the expiration of the initial Term of this Lease. This option to extend is personal to Tenant and may not be transferred or assigned to any third party.

B. Option Period Rent. The then fair market rental value of the Premises for the Option Period shall be determined as follows:

(i) The parties shall have thirty (30) days after Landlord receives the Option Notice within which to agree on the then fair market rental value of the Premises as defined in Paragraph 37.B.(ii). If the parties agree on the then fair market rental value of the Premises for the Option Period within thirty (30) days, they shall immediately execute an amendment to this Lease stating the Monthly Rent for the Option Period. If the parties are unable to agree on the then fair market rental value of the Premises for the Option Period within thirty (30) days, then, the then fair market rental value of the Premises shall be determined as provided in Paragraph 37.B.(iii).

(ii) The “then fair market rental value of the Premises” shall be defined to mean the fair market rental value of the Premises as of the commencement of the Option Period, taking into consideration all relevant factors, including the uses permitted under this Lease, the quality, size, design and location of the Premises, and the rent for comparable office/R&D space located in Scotts Valley, California.

(iii) Within seven (7) days after the expiration of the thirty (30)-day period set forth in paragraph 37.B.(i), each party, at its cost and by giving notice to the other party, shall appoint a real estate appraiser with at least five (5) years’ full-time commercial appraisal experience in the area in which the Premises are located to appraise and set the then fair market rental value of the Premises. If a party does not appoint an appraiser within ten (10) days after the other party has given notice of the name of its appraiser, the single appraiser appointed shall be the sole appraiser and shall set the then fair market rental value of the Premises. If the two appraisers are appointed by the parties as stated in this paragraph, they shall meet promptly and attempt to set the then fair market rental value of the Premises. If they are unable to agree within thirty (30) days after the second appraiser has been appointed, they shall attempt to elect a third appraiser meeting the qualifications stated in this paragraph within ten (10) days after the last day the two appraisers are given to set the then fair market rental value of the Premises. If they are unable to agree on the third appraiser, either of the parties to this Lease, by giving ten (10) days’ notice to the other party, can apply to the then Presiding Judge of the Santa Clara County Superior Court, for the selection of a third appraiser who meets the qualifications stated in this paragraph. Each of the parties shall bear one-half (1/2) of the cost of appointing the third appraiser and of paying the third appraiser’s fee. The third appraiser, however selected, shall be a person who has not previously acted in any capacity for either party.

Within thirty (30) days after the selection of the third appraiser, a majority of the appraisers shall set the then fair market rental value of the Premises. If a majority of the appraisers are unable to set the then fair market rental value of the Premises within the stipulated period of time, the three appraisals shall be added together and their total divided by three; the resulting quotient shall be the then fair market rental value of the Premises. If, however, the low appraisal and/or the high appraisal are/is more than ten percent (10%) lower and/or higher than the middle appraisal, the low appraisal and/or the high appraisal shall be disregarded. If only one appraisal is disregarded, the remaining two appraisals shall be added together and their total divided by two; the resulting quotient shall be the then fair market rental value of the Premises. If both the low appraisal and the high appraisal are disregarded as stated in this paragraph, then only the middle appraisal shall be used as the result of the appraisal. After the fair market rental value of the Premises has been set, the appraisers shall immediately notify the parties and the parties shall amend this Lease to set forth the Monthly Rent for the Option Period.



12. Brokers. Landlord and Tenant each represent and warrant it has had no dealings with any real estate broker or agent in connection with the negotiation of this Second Amendment other than JR Parrish Commercial Real Estate, and it knows of no other real estate broker or agent who is or might be entitled to a commission in connection with this Second Amendment. Landlord and Tenant shall indemnify, defend and hold each other harmless from any and all liabilities and expenses, including attorneys' fees and costs, arising out of or in connection with any claims asserted by any other broker or agent who represented, or allegedly represented, the indemnifying party in connection with this Second Amendment.

13. No Other Modifications. Except as set forth in this Second Amendment, the Lease is unmodified and in full force and effect.

LANDLORD

GRANITE CREEK BUSINESS CENTER,  
a California general partnership

By: TBI-SV III, a California general partnership,  
General Partner

By: /s/ Charles J. Toeniskoetter  
Charles J. Toeniskoetter, Trustee of  
the Toeniskoetter 2001 Living Trust  
dated December 19, 2001

By: Westwood Company Scotts Valley,  
a California general partnership,  
General Partner

By: /s/ Anthony C. Morici  
Anthony C. Morici, Trustee of the  
Morici Separate Property Trust  
dated June 3, 1983

TENANT

VIRNETX, INC., a Delaware corporation

By: /s/ Kathleen J. Sheehan

Its: CAO

## Subsidiaries of Registrant

Name of Entity	Jurisdiction of Incorporation or Organization
Network Research Corporation Japan Ltd. (known as Network Research Corporation Japan Kabushiki Kaisha in Japan)	Japan
VirnetX Inc.	Delaware

**Exhibit 23.1**

**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

We hereby consent to the incorporation by reference in the Registration Statements on Forms S-3 (Nos. 333-149884) and S-8 (No. 333-149883) of our report dated March 31, 2009, (which contains an explanatory paragraph relating to the Company's ability to continue as a going concern as described in Note 1 to the financial statements) relating to the financial statements of VirnetX Holding Corporation as of December 31, 2008 and 2007 and for the years then ended and for the period from August 2, 2005 (date of inception) to December 31, 2008, which appear in this Form 10-K.

/s/ Farber Hass Hurley LLP

Granada Hills, CA  
March 31, 2009

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER  
PURSUANT TO EXCHANGE ACT RULE 13a-14(a)/15d-14(a)  
AS ADOPTED PURSUANT TO SECTION 302  
OF THE SARBANES-OXLEY ACT OF 2002**

I, Kendall Larsen, certify that:

1. I have reviewed this Annual Report on Form 10-K of VimetX Holding Corporation (the “Registrant”);
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this report;
4. The Registrant’s other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the Registrant’s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the Registrant’s internal control over financial reporting that occurred during the Registrant’s most recent fiscal quarter (the Registrant’s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Registrant’s internal control over financial reporting; and
5. The Registrant’s other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant’s auditors and the audit committee of the Registrant’s board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant’s ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant’s internal control over financial reporting.

Dated: March 31, 2009

/s/ Kendall Larsen  
Kendall Larsen  
*Chief Executive Officer and President*

**CERTIFICATION OF CHIEF FINANCIAL OFFICER  
PURSUANT TO EXCHANGE ACT RULE 13a-14(a)/15d-14(a)  
AS ADOPTED PURSUANT TO SECTION 302  
OF THE SARBANES-OXLEY ACT OF 2002**

I, William E. Sloney, certify that:

1. I have reviewed this Annual Report on Form 10-K of VimetX Holding Corporation (the “Registrant”);
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this report;
4. The Registrant’s other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the Registrant’s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the Registrant’s internal control over financial reporting that occurred during the Registrant’s most recent fiscal quarter (the Registrant’s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Registrant’s internal control over financial reporting; and
5. The Registrant’s other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant’s auditors and the audit committee of the Registrant’s board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant’s ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant’s internal control over financial reporting.

Dated: March 31, 2009

/s/ William E. Sloney  
William E. Sloney  
*Chief Financial Officer*

**CERTIFICATION  
PURSUANT TO 18 U.S.C. SECTION 1350  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the accompanying Annual Report of VimetX Holding Corporation (the "Company"), on Form 10-K for the year ended December 31, 2008 (the "Report"), I, Kendall Larsen, Chief Executive Officer of the Company, hereby certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: March 31, 2009

/s/ Kendall Larsen  
Kendall Larsen  
*Chief Executive Officer and President*

**CERTIFICATION  
PURSUANT TO 18 U.S.C. SECTION 1350  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the accompanying Annual Report of VimetX Holding Corporation (the "Company"), on Form 10-K for the year ended December 31, 2008 (the "Report"), I, William E. Sliney, Chief Financial Officer of the Company, hereby certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: March 31, 2009

/s/ William E. Sliney

William E. Sliney  
*Chief Financial Officer*