



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

**Form SB-2**  
**Amendment No. 2**

to  
**REGISTRATION STATEMENT**  
**UNDER**  
**THE SECURITIES ACT OF 1933**

**VIRNETX HOLDING CORPORATION**

**Delaware**  
*(State of  
Incorporation)*

*(Name of small business issuer in its charter)*

**8980**

*(primary standard industrial  
classification code number)*

**77-0390628**  
*(I.R.S. Employer  
Identification No.)*

**5615 Scotts Valley Drive, Suite 110**  
**Scotts Valley, California 95066**  
**(831) 438-8200**

*(Address and telephone number of principal executive offices and principal place of business)*

**Kendall Larsen**  
**Chief Executive Officer**  
**VirnetX, Inc.**

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**Scotts Valley, California 95066**  
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**Approximate date of proposed sale to the public:** As soon as practicable after the effective date of this registration statement.

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act of 1933, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering:

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering:

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering:

If delivery of the prospectus is expected to be made pursuant to Rule 434, check the following box:

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act, other than securities offered only in connection with dividend or interest reinvestment plans, check the following box:

**CALCULATION OF REGISTRATION FEE**

Title of Each Class of Securities to be Registered	Proposed Maximum Aggregate Offering Price	Amount of Registration Fee
Common stock, par value \$0.0001 per share	\$37,400,000(1)(2)	\$1,149(3)

(1) On a post-split basis, this includes:

- 3,000,000 shares of common stock that are being registered for sale by the Registrant;
- 450,000 shares of common stock that are being registered in connection with an over-allotment option granted to the underwriter;
- 300,000 shares of common stock underlying the warrant issued to the underwriter;
- 5,333,333 shares of common stock being registered for resale by certain stockholders of the Registrant; and
- 266,667 shares of common stock underlying certain warrants being registered for resale by certain warrant holders of the Registrant.

Pursuant to Rule 416 under the Securities Act, this registration statement also covers such number of additional shares of common stock to prevent dilution resulting from stock splits, stock dividends or similar transactions.

- (2) Estimated solely for the purpose of calculating the registration fee in accordance with Rule 457(o) under the Securities Act.
- (3) Fee previously paid.

**The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the Registration Statement shall become effective on such date as the Securities and Exchange Commission acting pursuant to said Section 8(a) may determine.**

**EXPLANATORY NOTE**

This registration statement contains two prospectuses.

The first prospectus forming a part of this registration statement is to be used in connection with the underwritten public offering of 3,750,000 shares of common stock, on a post-split basis, including 450,000 shares subject to the underwriter's over-allotment option and 300,000 shares subject to the warrant to be issued to the underwriter. The first prospectus immediately follows this explanatory note.

The second prospectus forming a part of this registration statement is to be used in connection with the resale by named stockholders and warrant holders of PASW of up to 5,600,000 shares of common stock of PASW, on a post-split basis.

The second prospectus will consist of:

- the cover page and inside cover page immediately following the first prospectus on pages SS-1 and SS-2, which will replace such pages in the first prospectus;
  - the sections entitled "Selling Security Holders" and "Plan of Distribution" on pages SS-3 and SS-4 which will appear in place of the section entitled "Underwriting" in the first prospectus;
  - pages 1 through 43 of the first prospectus, other than the section entitled "Underwriting;"
  - pages F-1 through F-54 of the first prospectus; and
  - the back cover page, which immediately follows the inside back cover page of the first prospectus, which will replace such page in the first prospectus.
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The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and it is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

**SUBJECT TO COMPLETION, DATED NOVEMBER 5, 2007**

**PRELIMINARY PROSPECTUS**

# VIRNETX HOLDING CORPORATION

## 3,000,000 Shares Common Stock

We are offering 3,000,000 shares of our common stock.

Our common stock is quoted on the OTC Bulletin Board under the symbol "VNXH." On October 30, 2007, the last reported sales price of our common stock as reported on the OTC Bulletin Board was \$5.00 per share (on a post-split basis). We have applied for listing on the Nasdaq Capital Market to take effect prior to the closing of the offering.

We have also registered by a separate prospectus the resale by our existing stockholders and warrant holders of up to 5,600,000 shares of our common stock.

**Investing in our common stock involves a high degree of risk. Please carefully consider the "Risk Factors" beginning on page 5 of this prospectus.**

**NEITHER THE SECURITIES AND EXCHANGE COMMISSION NOR ANY STATE SECURITIES COMMISSION HAS APPROVED OR DISAPPROVED OF THE SHARES OF COMMON STOCK OR PASSED ON THE ADEQUACY OR ACCURACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.**

	<u>Per Share</u>	<u>Total</u>
Price to public	\$	\$
Underwriting discount	\$	\$
Proceeds, before expenses, to PASW	\$	\$

Our underwriter is offering these shares on a firm commitment basis and expects that delivery of shares will be made on or about \_\_\_\_\_, 2007. We have granted the underwriter a 45-day option to purchase up to 450,000 additional shares (on a post-split basis) from us at the public offering price, less the underwriting discount, to cover over-allotments. In addition, we will issue to the underwriter a warrant to purchase 300,000 shares (on a post-split basis) of our common stock. Both the underwriter's over-allotment option and warrant are subject to adjustment for stock splits, stock dividends or similar transactions.

## Gilford Securities Incorporated

, 2007

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## SUMMARY

*The following summary provides an overview of certain information about our company and the offering and may not contain all the information that may be important to you. This summary is qualified in its entirety by and should be read together with the information contained in other parts of this prospectus. You should carefully read this entire prospectus before making a decision about whether to invest in our common stock.*

### **Our Company**

From inception in 1992 until January 2003, VirnetX Holding Corporation (through its predecessor corporation) was engaged in the business of developing and licensing software that enabled internet and web based communications. As of January 31, 2003, we had sold all of our operating assets, and since such time our only source of revenue has been derived from nominal royalties payable to our wholly-owned Japan subsidiary, Network Research Corp. Japan, Ltd. pursuant to the terms of a single license agreement. We acquired VirnetX as a wholly-owned subsidiary on July 5, 2007 and ceased being a shell company. Additionally, pursuant to the merger with VirnetX, we experienced a change in control, with the former securityholders of VirnetX acquiring control of VirnetX Holding Corporation.

Our wholly owned subsidiary, VirnetX, was incorporated in the State of Delaware in August 2005. It is a development stage company that was formed to commercialize a patent portfolio for providing solutions for secure real-time communications such as instant messaging, or “IM,” and voice over internet protocol, or “VoIP.” VirnetX has acquired certain patents from Science Applications International Corporation, a systems, solutions and technical services company based in San Diego, California (better known as “SAIC”).

### **Principal Products and Services**

#### ***Technology and Solutions Business***

Our primary strategy for our technology and solutions business is to commercialize our patented technology in the area of secure real-time communication. We are developing technology for:

- “single-click” and “zero-click” security solutions for real-time communications; and
- “end-to-end” security for VoIP, video conferencing and other types of peer-to-peer collaboration without degradation in quality of service.

In addition, we expect to continue to generate nominal royalties payable to our Japan subsidiary pursuant to the terms of a single license agreement.

#### ***Contract Services Business***

Our primary strategy for our contract services business is to leverage our research and development group to provide contract research, prototyping, systems integration and technical services to numerous branches of the U.S. Federal government, network service providers and other OEM partners. Our team is staffed with nationally accredited scientists who have experience with research and development projects concerning industry-wide security solutions as well as national security. We intend to provide these contract services to assist the research and development efforts of our corporate and OEM developers by providing outsourced research, deployment and testing services designed to secure and simplify networks.

We believe that the revenue generated by our contract services business will eventually partially offset the costs of our technology and solutions business and will provide us with the opportunity to generate future strategic relationships and licensing opportunities. We also anticipate that future contract services projects will enable us to develop promising new technologies that can be commercialized through our technology and solutions business.

### **Microsoft Litigation**

We believe Microsoft Corporation is infringing certain of our patents including certain patents we acquired from SAIC. Accordingly, on February 15, 2007, we filed a complaint against Microsoft in the United States District

Court for the Eastern District of Texas, Tyler Division. Pursuant to our amended complaint, we allege that Microsoft infringes three of our U.S. patents. We are seeking both damages, in an amount subject to proof at trial, and injunctive relief. Microsoft has 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 consider this Microsoft lawsuit to be of critical importance to our company and our future business opportunities, so we are devoting a substantial portion of our resources to our litigation efforts. We expect this litigation to be extremely expensive and there is no guarantee of success. You should carefully read about the risk factors associated with this lawsuit in the section titled "Risk Factors" herein. In addition, SAIC will receive a significant percentage of any recovery we may obtain from Microsoft. You should also carefully review the section herein titled "Assignment of Patents," which describes in detail the terms of SAIC's rights with respect to the Microsoft litigation as well as their rights to other licensing proceeds and litigation awards we may receive in the future.

#### Summary Financial Data

*The summary financial data set forth below is derived from our financial statements and notes thereto, and should be read in conjunction with, and is qualified in its entirety by reference to, our consolidated financial statements and notes thereto and the information contained under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations," in each case appearing elsewhere in this prospectus.*

For accounting purposes, VirnetX Holding Corporation was a publicly-held shell company prior to the merger with VirnetX. VirnetX security holders own approximately 95% of the combined company on a fully-diluted basis post merger and VirnetX directors and executive management constitute a majority of the combined company's board of directors and executive management, respectively. Therefore, the merger between VirnetX Holding Corporation and VirnetX is considered a reverse acquisition of assets and a recapitalization with VirnetX deemed to be the acquiror of VirnetX Holding Corporation.

In light of the fact that VirnetX is deemed to be the acquiror as described above, the historical financial information of VirnetX has been presented as the historical financial information of the Company throughout this prospectus.

#### Statement of Operations Data

	For the Period August 2, 2005 (Date of Inception) to December 31, 2005	Year Ended December 31, 2006	Six Months Ended June 30, 2007
Total operating expenses:	\$ 882,478	\$ 1,407,675	\$ 1,966,425
Total other (income) expenses, net:	—	(6,336)	45,488
Net loss:	<u>\$ 882,478</u>	<u>\$ 1,401,339</u>	<u>\$ 2,011,913</u>

#### Balance Sheet and Other Data

	As of December 31, 2005	As of December 31, 2006	As of June 30, 2007
Cash and cash equivalents:	\$ 86,552	\$ 139,997	\$ 86,835
Total assets:	\$ 147,722	\$ 195,123	\$ 604,986
Accounts payable:	\$ —	\$ 87,386	\$ 897,297
Total stockholders' equity (deficit):	\$ (82,278)	\$ 107,737	\$ (1,842,311)

### The Offering

<b>Common stock offered by us</b>	3,000,000 shares
<b>Common stock to be outstanding after this offering</b>	37,859,453 shares(1)
<b>Use of proceeds</b>	We intend to use the proceeds from the offering to fund the development of our products, to increase staffing, to fund our litigation efforts and for other general corporate purposes. See "Use of Proceeds" for more information.
<b>Risk Factors</b>	Investing in our common stock involves a high degree of risk. Please carefully consider the "Risk Factors" beginning on page 5 of this prospectus.
<b>OTC Bulletin Board symbol</b>	VNXH. We have applied for listing on the Nasdaq Capital Market to take effect prior to the closing of the offering.

- (1) The number of shares of common stock to be outstanding after this offering includes the sum of: (a) 31,217,198 shares of our common stock outstanding as of October 31, 2007; (b) 566,667 shares of our common stock issuable upon exercise of our warrants outstanding as of October 31, 2007, including 300,000 shares of our common stock issuable upon exercise of the warrant to be issued to the underwriter in connection with this offering; and (c) 3,091,569 shares of our common stock issuable upon exercise of our options outstanding as of October 31, 2007. The number of shares of common stock to be outstanding after this offering assumes no exercise of the underwriter's over-allotment option.

### Corporate Information

Our principal executive offices are located at 5615 Scotts Valley Drive, Suite 110, Scotts Valley, California 95066, and our phone number is (831) 438-8200. We maintain a website at [www.virnetx.com](http://www.virnetx.com). Information contained on our website does not comprise a part of this prospectus.

VirnetX is a trademark in the United States. This prospectus includes product names, trade names and trademarks of other companies. All other product names, trade names and trademarks appearing in this prospectus are the property of their respective holders.

As used in this prospectus:

- "VirnetX" refers to VirnetX, Inc., a Delaware corporation;
- "VirnetX Holding Corporation (formerly PASW, Inc.)" refers to VirnetX Holding Corporation, a Delaware corporation, on and after our reincorporation which became effective on May 30, 2007 and name change which became effective on October 29, 2007, and refers to PASW, Inc., a California corporation, prior to that date;
- "the merger" refers to the merger which became effective on July 5, 2007, by and among VirnetX, VirnetX Holding Corporation and a wholly-owned subsidiary of VirnetX Holding Corporation, whereby VirnetX merged with, and became, a wholly-owned subsidiary of VirnetX Holding Corporation and VirnetX Holding Corporation issued shares of its common stock to the stockholders of VirnetX as consideration for the merger; and
- "we," "our," "us" and "the company" refer to VirnetX Holding Corporation and its wholly-owned subsidiaries, including VirnetX, collectively, on a consolidated basis after giving effect to the merger.



Unless otherwise noted in this prospectus, all information in this prospectus assumes:

- we have completed a 1 for 3 reverse stock split, which became effective on October 29, 2007;
- no exercise of the underwriter's over-allotment option; and
- no exercise of outstanding options and warrants exercisable for shares of our common stock consisting of the following:
  - 266,667 shares of our common stock issuable upon exercise of our warrants outstanding as of October 31, 2007;
  - 300,000 shares of our common stock issuable upon exercise of the warrant to be issued to the underwriter in connection with this offering; and
  - 3,091,569 shares of our common stock issuable upon exercise of our options outstanding as of October 31, 2007.

## RISK FACTORS

*You should carefully consider the following material risks in addition to the other information set forth in this prospectus before making any investment in our common stock. 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 our stock.*

### **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. 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. While these legal proceedings have just recently begun, we anticipate that they may continue for several months or years and may require significant expenditures for legal fees and other expenses. The time and effort 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 costly, which may negatively impact our financial condition.

***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. Patent litigation is inherently risky and the outcome is uncertain. Microsoft is a large, well-financed company with substantially greater resources. 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. 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 our business strategy 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 a substantially greater amount of time, attention and financial resources to compliance with U.S. securities laws than was the case for VirnetX as a private company prior to the merger with VirnetX Holding Corporation. This shift in focus 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. This information will enable our litigation opponents to develop more effective litigation strategies that are contrary to our interests. We may, from time to time, be required to disclose information that will have a material adverse affect on our litigation strategies.

*We may commence additional legal proceedings against third parties who we believe are infringing on our intellectual property rights, and such legal proceedings may be costly and time-consuming.*

We may have potential intellectual property infringement claims against other parties, in addition to our claims against Microsoft. If management decides to commence actions against any of these additional parties, doing so may be expensive and time-consuming, which may adversely affect our financial condition and operations. Moreover, there will be no assurance that we would be successful in these additional legal proceedings. Commencing lawsuits may lead to potential counterclaims which may preclude our ability to commercialize our initial products, which are currently in development.

**Risks related to our business and our industry**

*Based on our historical financial statements, there is uncertainty as to our ability to continue as a going concern.*

In the event that we are unable to achieve or sustain profitability or are otherwise unable to secure additional external financing, we may not be able to meet our obligations as they come due, raising substantial doubts as to our ability to continue as a going concern. Any such inability to continue as a going concern may result in our security holders losing their entire investment. Our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America, contemplate that we will continue as a going concern and do not contain any adjustments that might result if we were unable to continue as a going concern. Notwithstanding the foregoing, our cash flow deficiencies raise substantial doubt as to our ability to continue as a going concern and our auditors have added an emphasis paragraph to their opinion raising a question of our ability to continue as a going concern. Also, changes in our operating plans, our existing and anticipated working capital needs, the acceleration or modification of our expansion plans, lower than anticipated revenues, increased expenses, or other events will all affect our ability to continue as a going concern.

*We anticipate incurring operating losses and negative cash flows in 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.

Any increases in our operating expenses will require us to achieve significant revenue before we can attain profitability. In the event that we are unable to achieve profitability or raise sufficient funding to cover our losses, we may not be able to meet our obligations as they come due, raising substantial doubts as to our ability to continue as a going concern.

*We will need additional capital to pursue our litigation strategy, conduct our operations and develop our products, and our ability to obtain the necessary funding is uncertain.*

We will require significant additional capital resources from sources including equity and/or debt financings, license arrangements, grants and/or collaborative research arrangements in order to develop and commercialize our products and continue operations and we intend to raise such additional capital. Our current rate of expenditure is approximately \$350,000 per month excluding capital expenditures. However, this rate of expenditure is expected to increase to approximately \$800,000 per month by November 1, 2007 due to, among other things, our anticipated

need to hire additional employees, lease additional office space and increase our research and development investment. If we raise additional equity capital our existing stockholders will experience dilution.

*We are a development stage company with virtually no revenues currently and for the foreseeable future.*

VirnetX is a development stage company with no revenues and VirnetX Holding Corporation has a very small amount of revenue from its Japan subsidiary under a single license agreement. On a consolidated basis, we have virtually no revenues and do not expect to generate additional revenues for the foreseeable future. We will need to raise additional equity financing to fund our operations and especially our litigation against Microsoft and there can be no assurance that we will be successful in doing so on acceptable terms or at all.

*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. If our rights in our patents were restricted or ultimately lost, our ability to continue our business based on the affected technology platform could be severely adversely affected.

*Our business model 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 secure communication for IM and VoIP; however, this is not a defined market. Rather, it represents a new business model, for which there are no assurances that we will succeed in building a profitable business. 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 messaging and collaboration solutions based on session initiation protocol (better known as "SIP"). There can be no assurance that such adoption will occur. If we are unable to attract significant licensing fees, our operations and financial condition will be adversely affected.

*We will rely on third parties for software and hardware development, manufacturing content and technology services.*

We expect to rely on third party developers to provide software and hardware. If we experience problems with any of our third party technology or products, our customers' satisfaction could be reduced, and our business could be adversely affected. In addition, we expect to rely on third parties to provide content through strategic relationships and other arrangements. If we experience difficulties in maintaining these relationships or developing new relationships on a timely basis and on terms favorable to us, our business and financial condition could be adversely affected.

*Malfunctions of third party hosting services could adversely affect their business, which may impede our ability to attract and retain strategic partners and customers.*

The products we are developing will be highly dependent on internet traffic and reliability. 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 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 communication: 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.

*There has been increased competition 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.*

Competition for securing IM and VoIP services is intense. We are aware of similar products and services that will compete directly with our proposed products and services, and some of the companies developing these similar products and services are 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:

- 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, 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.

*Our business model depends on our ability to successfully develop and operate our networks and deploy new offerings and technology.*

There can be no assurances that we will not experience reliability problems in the future. Any reliability problems that adversely affect our ability to operate our networks would likely reduce revenues and restrict the growth of our business. Our future success will also depend in part on other factors, including, but not limited to, our ability to:

- find secure hosting;
- enhance our offerings;
- address the needs of our prospective users;
- respond to technological advances and emerging industry standards and practices on a timely and cost-effective basis; and
- develop, enhance and improve the responsiveness, functionality and features of our infrastructure services and networks.

If we are unable to integrate and capitalize on new technologies and standards effectively, our business could be adversely affected.

*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 growing employee base.

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 do not successfully develop our planned products and services in a cost-effective manner to meet 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.

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 proprietary 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 capital expenditures.

***Our business greatly depends on the development and growth of IM and VoIP.***

The use of the internet for communications utilizing IM and VoIP is a recent development, and the continued demand and growth of a market for IM and VOIP services and products is uncertain. The internet may ultimately prove not to be a viable commercial marketplace for IM and VOIP services for a number of reasons, including:

- unwillingness of consumers to shift to VoIP;
- refusal to purchase security products;
- 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.

***While the use of IM has grown rapidly in personal and professional use, there can be no assurance that users will pay to secure their IM services.***

Many services such as Microsoft, Yahoo! and AOL offer IM free of charge. However, security solutions for these services are not free, and users of IM may not want to pay for such security solutions. If users do not want to pay for the security solutions, we will have difficulty marketing and selling our products and technologies.

***If the market for VoIP service does not develop as anticipated, our business would be adversely affected.***

The success of our products that secure enterprise VoIP service depends on the growth in the number of VoIP users, which in turn depends on wider public acceptance of VoIP telephony. The VoIP communications medium is in its early stages and may not develop a broad audience. 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. Potential users may also view more familiar online communication methods, such as e-mail or IM, as sufficient for their communications needs. There is no assurance that VoIP will ever achieve broad public acceptance.

***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 product 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.

***If we are not able to adequately protect our proprietary 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 proprietary 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. 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 proprietary rights would have a negative impact on our operations and revenues.

***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 likely to arise in the future. We have already begun legal proceedings against Microsoft to defend our intellectual property rights, and we may be forced to litigate against other competitors to enforce or defend our intellectual property rights, to protect our trade secrets or to determine the validity and scope of other parties' proprietary rights. Any such litigation could be very costly and could distract our management from focusing on operating our business. The existence and outcome of any such litigation could harm our business. Additionally, any such costs we incur to defend or protect our intellectual property rights could greatly impact our financial condition.

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.

***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. It is possible that Congress and some state legislatures may seek to impose increased fees and administrative burdens on VoIP, data, and video providers. The U.S. Federal Communications Commission may seek to impose traditional telephony requirements such as disability access requirements, consumer protection requirements, number assignment and portability requirements, and other obligations. 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.

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 secure communications 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.

***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 other countries. 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
- higher costs associated with doing business internationally.

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

***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. 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 the growth of our business. We expect to face competition in the recruitment of qualified personnel, and we can provide no assurance that we will attract or retain such personnel.

***We will incur increased costs as a result of being a public company, compared to VirnetX's historical operations as a private company.***

As a public company, we will 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. Additionally, with the acquisition of VirnetX and the termination of our status as a shell company, we will incur additional costs associated with our public company reporting requirements.

***In connection with an audit that was conducted of VirnetX, VirnetX's independent auditors identified material weaknesses in VirnetX's internal controls over financial reporting.***

Prior to the merger between VirnetX Holding Corporation and VirnetX, as a development stage, privately held company, VirnetX historically did not maintain formal or documented internal controls over financial reporting of the same character as is generally maintained by public companies. Prior to its preparations for the merger, VirnetX utilized the cash basis of accounting and was not required to have its financial statements audited or reviewed. Prior to the merger, VirnetX engaged independent auditors to audit its financial statements for certain prior periods. We have been informed that during the course of that audit, VirnetX's independent auditors concluded that VirnetX's internal controls over financial reporting suffer from certain "material weaknesses" as defined in standards established by the Public Company Accounting Oversight Board and the American Institute of Certified Public Accountants. Since VirnetX is now our wholly-owned subsidiary, the material weaknesses in VirnetX's internal controls over financial reporting will likely result in our having material weaknesses in our internal controls over financial reporting. We intend to commence a process of developing, adopting and implementing policies and procedures to address such material weaknesses that are consistent with those of small, public companies. However, that process may be time consuming and costly and there is no assurance as to when we will effectively address such material weaknesses.

***Our inability to become compliant with the internal controls requirements of Section 404 of the Sarbanes Oxley Act could negatively affect our stock price and limit our ability to raise additional equity financing.***

Burr, Pilger & Mayer LLP, the independent audit firm retained to audit the 2005 and 2006 financial statements for our wholly-owned subsidiary and principal operating company, VirnetX, Inc., resigned on October 26, 2007. The reason for the resignation was concern that we would not become compliant with the internal controls requirements of Section 404 of the Sarbanes Oxley Act by December 31, 2007 and due to an insufficient quantity of experienced resources involved with the financial reporting and period closing process. We are not currently compliant with these internal controls requirements and there can be no assurance we will be successful in becoming compliant in time for Farber Hass Hurley & McEwen, LLP, our independent audit firm, to conclude we have no "material weaknesses" and are otherwise compliant when they perform their audit with respect to our 2007 financial statements. Our lack of compliance with internal controls requirements of Section 404 of the Sarbanes Oxley Act could negatively affect our stock price, make us less attractive to our stockholders, jeopardize our listing status with Nasdaq and limit our ability to raise additional equity financing through sales of our stock.

**Risks related to our stock**

***Trading in our common stock is limited and the price of our common stock may be subject to substantial volatility.***

Our common stock is traded on the OTC Bulletin Board, and therefore the trading volume is more limited and sporadic than if our common stock were traded on the Nasdaq Stock Market or a national stock exchange such as the American Stock Exchange. Although we have applied for listing on the Nasdaq Capital Market, there can be no assurance that we will remain listed on such exchange if accepted. Additionally, the price of our common stock may 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 is concentrated, you and other investors will have minimal influence on stockholder decisions.***

Our officers and directors will beneficially own a majority of the outstanding common stock after this offering. Our officers and directors will effectively control matters requiring stockholder approval, and you and other investors will have minimal influence over the election of directors or other stockholder actions. As a result, these officers and directors could approve or cause PASW to take actions of which you disapprove or that are contrary to your interests. This ability to exercise control over all matters requiring stockholder approval could prevent or significantly delay another company from acquiring or merging with us.

***A significant number of shares of our stock will be registered for resale by certain stockholders and sales of those shares may drive down the price of our stock.***

Prior to the merger between VirnetX Holding Corporation and VirnetX, there were only 1,665,800 shares of VirnetX Holding Corporation common stock issued and outstanding and trading on the OTC Bulletin Board. Of the 31,217,198 shares of VirnetX Holding Corporation common stock that were issued and outstanding as of October 31, 2007, there are 5,600,000 shares (including 266,667 shares underlying outstanding warrants) that will be registered for resale upon the closing of this offering. The remaining shares will be eligible for resale under Rule 144 under the Securities Act of 1933, on the first anniversary of the closing of the merger which occurred on July 5, 2007. The SEC currently has proposed amendments to Rule 144 which could make these shares eligible for resale as early as six months after the closing of the merger. Sales of these shares may materially and adversely affect the market price of our common stock.

***Our protective provisions could make it more 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 the company 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 the Board of Directors since it will 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 common stock in a manner that is materially dilutive to exiting 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 will have 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 in order to have the matter voted on at the 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 delaying a stockholder proposal to a subsequent meeting to the extent such proposal is not raised in a timely manner for an upcoming meeting.
- *Elimination of stockholder actions by written consent:* this has the effect of eliminating the ability of a stockholder or a group of stockholders representing a majority of the outstanding shares to 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:* our By-laws may be altered or amended or new By-laws adopted by the affirmative vote of at least 66<sup>2</sup>/<sub>3</sub>% of the outstanding shares. This has the effect of requiring a substantially greater vote of the stockholders to approve any changes to our By-laws.
- *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 shares, may need to wait for the annual meeting before nominating directors or raising other business proposals to be voted on by the stockholders.

***“Penny stock” regulations may impose certain restrictions on the marketability of our securities.***

The SEC has adopted regulations which generally define a “penny stock” to be any equity security that has a price of less than \$5.00 per share or an exercise price of less than \$5.00 per share, subject to certain exceptions (including the issuer of the securities having net tangible assets (*i.e.*, total assets less intangible assets and liabilities) in excess of \$2,000,000 or average revenue of at least \$6,000,000 for the last three years). As a result, our common stock could be subject to these rules that impose additional sales practice requirements on broker-dealers who sell our securities to persons other than established customers and accredited investors (generally persons with a net worth in excess of \$1,000,000 or annual income exceeding \$200,000, or \$300,000 together with their spouse). For transactions covered by these rules, the broker-dealer must make a special suitability determination for the purchase of such securities and have received the purchaser’s written consent to the transaction prior to the purchase. Additionally, for any transaction involving a “penny stock,” unless exempt, the rules require the delivery, prior to the transaction, of a risk disclosure document mandated by the SEC relating to the “penny stock” market. The broker-dealer must also disclose the commissions payable to both the broker-dealer and the registered representative, current quotations for the securities and, if the broker-dealer is the sole market maker, the broker-dealer must disclose this fact and the broker-dealer’s presumed control over the market. Finally, monthly statements must be sent disclosing recent price information for the “penny stock” held in the account and information on the limited market in “penny stocks.” Consequently, although the “penny stock” rules do not currently apply to our securities, if these rules do become applicable in the future, this may restrict the ability of broker-dealers to sell our securities.

***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 any. 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 visibility in the financial markets, which could cause our stock price or trading volume to decline.

***You will incur immediate substantial dilution by purchasing securities in this offering.***

The public offering price applicable to the common stock is expected to be substantially higher than the book value per share of the common stock before the offering. By purchasing securities in this offering you will incur immediate substantial dilution. See “Dilution.”

***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, and the holders of any debt we may issue would have rights superior to your rights in the event we are not successful and are forced to seek the protection of the bankruptcy laws.

*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 retain all funds and any earnings for use in the operation and expansion of our business.

#### **FORWARD-LOOKING STATEMENTS**

This prospectus 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 prospectus, including statements regarding our 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 prospectus. These risks are not exhaustive. Other sections of this prospectus 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.

#### **USE OF PROCEEDS**

We intend to use the proceeds of the offering for general corporate purposes, including working capital, funding our litigation efforts and other general and administrative expenses. We have not identified the amounts we plan to spend on each of these areas or the timing of expenditures. Pending specific application of the net proceeds, we plan to invest the net proceeds in short-term, investment grade, interest-bearing securities.

#### **DIVIDEND POLICY**

We have not in the past paid, and do not expect for the foreseeable future to pay, dividends on our common stock. Instead, we anticipate that all of our earnings, if any, in the foreseeable future will be used for working capital and other general corporate purposes. Any future determination to pay dividends on our common stock will be at the discretion of our board of directors and will depend upon, among other factors, our results of operations, financial condition, capital requirements and contractual restrictions.

#### **DETERMINATION OF OFFERING PRICE**

The offering price for the shares to be sold in this offering was determined in discussions between the Company’s Chief Executive Officer, certain of the Company’s major stockholders and the underwriter. Because the Company’s stock is somewhat illiquid, the price was not determined with reference to the market price of the stock as quoted on the OTC Bulletin Board. The Company believes that the offering price represents a fair value for the Company’s shares of common stock.

**DILUTION**

All of the share and per share data presented below, unless explicitly stated otherwise, is shown on a post-split basis after giving effect to a 1 for 3 reverse stock split, which became effective on October 29, 2007. At December 31, 2006, pro forma net tangible book value was \$429,512, or \$0.01 per share. Pro forma net tangible book value per share represents our pro forma net tangible assets less liabilities divided by the pro forma shares of common stock outstanding.

After giving effect to our sale of 3,000,000 shares of common stock and our receipt of an estimated \$10,200,000 of net proceeds from the offering, based on an assumed offering price of \$4.00 per share, which is the minimum price necessary for listing on the Nasdaq Capital Market, pro forma adjusted net tangible book value at December 31, 2006 would have been \$0.31 per share. This represents an immediate increase in pro forma net tangible book value of \$0.30 per share to existing stockholders and an immediate dilution of \$3.69 per share of common stock to new investors purchasing units in the offering. The following table illustrates per share dilution:

Assumed public offering price per share		\$ 4.00
Net tangible book value per share prior to the offering	\$ 0.01	
Increase attributable to new investors	<u>0.30</u>	
Adjusted pro forma net tangible book value per share after the offering		<u>0.31</u>
Dilution per share to new investors in this offering		<u>\$ 3.69</u>

The following table sets forth, on a pro forma basis as of December 31, 2006, the number of shares (on a post-split basis) of common stock purchased from VirnetX and VirnetX Holding Corporation, the total consideration paid to VirnetX and VirnetX Holding Corporation and the average price per share paid by existing stockholders and new investors purchasing units in the offering, before deducting underwriting discounts and estimated offering expenses:

	Shares Purchased		Total Consideration		Average Price per Share
	Number	Percent	Amount	Percent	
Existing investors	31,217,198	91.23%	\$ 8,857,171	42%	\$ 0.28
New investors	3,000,000	8.77%	12,000,000	58%	4.00
Total	34,217,198	100.00%	\$ 20,857,171	100%	\$ 4.28

The information for existing stockholders in the table above excludes shares and warrants issuable upon exercise of outstanding options and warrants, including the underwriter's warrant to purchase shares and exercise of the underwriter's over-allotment option. To the extent that currently outstanding options or warrants are exercised at prices below \$4.00 per share, there will be further dilution to new investors.

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF  
FINANCIAL CONDITION AND RESULTS OF OPERATION**

*The following discussion should be read in conjunction with and is qualified in its entirety by reference to our consolidated financial statements included elsewhere in this prospectus. Except for the historical information contained herein, the discussions in this section contain forward-looking statements that involve risks and uncertainties. Actual results could differ materially from those discussed below. See "Risk Factors" and "Forward-Looking Statements" for a discussion of these risks and uncertainties.*

**Recent Events**

On July 5, 2007 VirnetX, Inc., a Delaware corporation ("VirnetX"), entered into a binding agreement and plan of merger with VirnetX Holding Corporation, a Delaware corporation (formerly, PASW, Inc.). Under the terms of the agreement, on July 5, 2007, VirnetX Holding Corporation and VirnetX consummated a reverse triangular merger in which VirnetX Holding Corporation's wholly-owned acquisition subsidiary merged with and into VirnetX with VirnetX as the surviving corporation to the merger. As a result of the merger, VirnetX became a wholly-owned subsidiary of VirnetX Holding Corporation and the pre-merger stockholders of VirnetX exchanged their shares in VirnetX for shares of common stock of VirnetX Holding Corporation. The key terms of the merger include the following:

- the officers and directors of VirnetX Holding Corporation, except for the chief financial officer, were replaced upon completion of the transaction so that the officers and directors of VirnetX became the officers and directors of VirnetX Holding Corporation;
- VirnetX's convertible notes payable of \$1,000,000 and \$3,000,000 of funds held in escrow were converted into VirnetX Holding Corporation common stock in July 2007;
- VirnetX's convertible notes payable of \$500,000 were converted into VirnetX Holding Corporation common stock in July 2007; and
- on a post-split basis, VirnetX Holding Corporation issued 29,551,398 shares of its common stock and stock options to purchase 1,743,670 shares of common stock from the pre-merger shareholders and option holders of VirnetX in exchange for 100% of the issued and outstanding capital stock and securities of VirnetX. Additionally, VirnetX Holding Corporation issued to MDB Capital Group, LLC and its affiliates, warrants to purchase an aggregate of 266,667 shares of common stock of VirnetX Holding Corporation pursuant to the provisions of the MDB Service Agreement, which was assumed by VirnetX Holding Corporation from VirnetX in connection with the merger.

In light of the foregoing, for accounting purposes, VirnetX has been treated as the acquiror of VirnetX Holding Corporation under a reverse merger.

**Company Overview**

VirnetX Holding Corporation's predecessor corporation was incorporated in the State of California in November 1992. VirnetX Holding Corporation was incorporated in the State of Delaware in April 2007 and on May 30, 2007 we filed a certificate of merger in Delaware pursuant to which we changed our domicile from California to Delaware. From inception until January 2003, we engaged in the business of developing and licensing software that enabled internet and web based communications. As of January 31, 2003, we sold all of our operating assets, and since such time our only source of revenue has been derived from nominal royalties payable to our wholly-owned Japan subsidiary, Network Research Corp. Japan, Ltd. pursuant to the terms of a single license agreement. In addition to our Japan subsidiary, we have three other wholly-owned subsidiaries, two of which are California corporations and the other of which is incorporated under the laws of the United Kingdom. These other subsidiaries are currently inactive. We had substantially no day to day operations since we sold all of our operating assets on January 31, 2003.

VirnetX was incorporated in the state of Delaware on August 2, 2005. VirnetX is a development stage company that is actively developing solutions for secure real-time communications such as instant messaging, or “IM,” and voice over internet protocol, or “VoIP,” in order to commercialize its patent portfolio in this area.

VirnetX acquired certain patents in 2006 from SAIC, pursuant to an assignment by SAIC to VirnetX of all of SAIC’s right, title and interest in and to such patents. VirnetX has granted SAIC an exclusive, royalty-free and perpetual license under these patents outside of VirnetX’s field of use. VirnetX has, and retains, all right, title and interest to these patent rights within VirnetX’s field of use, which consists of secure communications in areas of virtual private networks, or “VPNs,” VoIP, e-mail, video conferencing, communications logging, dynamic 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.” This field of use is not limited by any predefined transport mode or medium of communication (e.g., wire, fiber, wireless, or mixed medium). VirnetX’s patents embrace a set of functions relating to domain name system, or “DNS,” based security mechanisms for real-time communication.

VirnetX is in the development stage and consequently is subject to the risks associated with development stage companies, including the need for additional financings; the uncertainty of our intellectual property resulting in 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.

#### **Critical Accounting Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States 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.

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

VirnetX identifies and records 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. 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***

VirnetX accounts 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 the VirnetX’s financial instruments, including cash and cash equivalents, accounts payable, and accrued liabilities, approximate their fair values due to their short maturities.

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

VirnetX accounts for share-based compensation in accordance with Statement of Financial Accounting Standards (SFAS) 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*, VirnetX records 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 September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 157 "Fair Value Measurements" (better known as "SFAS 157"), which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those years. We are currently assessing the impact that the adoption of SFAS 157 may have on our financial position, results of operations or cash flows.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, "The Fair Value Option for Financial Assets and Liabilities" (better known as "SFAS 159"). SFAS 159 provides entities with the option to report selected financial assets and liabilities at fair value. Business entities adopting SFAS 159 will report unrealized gains and losses in earnings at each subsequent reporting date on items for which fair value option has been selected. SFAS 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. SFAS 159 requires additional information that will help investors and other financial statement users to understand the effect of an entity's choice to use fair value on its earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007, with earlier adoption permitted. VirnetX is currently assessing the impact that the adoption of SFAS 159 may have on our financial position, results of operations or cash flows.

#### **Operations**

VirnetX is in the development stage and has raised capital since its inception through the issuance of its equity securities. As of June 30, 2007, VirnetX had approximately \$86,835 in cash and \$488,165 in prepaid expenses and other current assets.

VirnetX has generated no revenue from operations and had expenses for the period from August 2, 2005 (date of inception) to June 30, 2007 of \$4,256,578, including research and development expenses of \$878,365 and general and administrative expenses of \$3,378,213.

Net cash used in operating activities for the period from August 2, 2005 (date of inception) to June 30, 2007 was approximately \$2,819,389, which primarily reflected a net loss of \$4,295,730, an increase to cash from an adjustment for stock-based compensation of \$1,053,464, a decrease to cash from a change in prepaid expenses of \$488,165 and an increase to cash from a change in accounts payable of \$897,297. We expect net cash used in operating activities to increase going forward as we pursue additional product development and enforcement of our patent rights.

Net cash used in investing activities was approximately \$43,731 for the period from August 2, 2005 (date of inception) to June 30, 2007, for the purchase of property and equipment.

Net cash provided by financing activities was approximately \$2,949,955 for the period from August 2, 2005 (date of inception) to June 30, 2007, which consisted primarily of net proceeds received from the issuance of preferred stock and the issuance of convertible notes.

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 development programs will result in products that will achieve market acceptance. Product candidates that may

appear to be promising at all stages of development may not reach the market for a number of reasons. Product candidates may be found ineffective or may take longer to progress through the beta trials than had been anticipated, may not be able to achieve the pre-defined endpoint due to changes in the environment, may fail to receive necessary approvals, may prove impracticable to manufacture in commercial quantities at reasonable cost and with acceptable quality, or may fail to achieve market acceptance. For these reasons, we are unable to predict the period in which material net cash inflows will commence with respect to our security products under development.

From inception, VirnetX's development efforts have been focused on our security products.

#### ***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.

VirnetX's research and development expenses increased significantly from \$56,000 for the period from August 2, 2005 (date of inception) to December 31, 2005 to \$554,187 for the full year ended December 31, 2006, to \$268,178 for the six-month period ended June 30, 2007 primarily as a result of increased engineering activities for product development. We expect research and development expenses to increase significantly as employees are hired to provide in-house research and development while we continue to use outside contractors for additional product development on a limited basis.

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

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

VirnetX's 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 the full year ended December 31, 2006. VirnetX's general and administrative expenses increased from \$399,622 for the six-month period ended June 30, 2006 to \$1,698,247 for the six-month period ended June 30, 2007. We expect general and administrative expenses to further increase significantly as outside counsel fees ramp up in connection with our patent infringement lawsuit against Microsoft Corporation and as outside counsel and accounting fees increase due to the significantly higher costs associated with becoming a public company and the associated expenses for reporting and other securities law compliance activities.

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

Since inception, VirnetX has financed its operations principally through private issuances of common and preferred stock. 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 has included funding research and development, litigation efforts and working capital needs.

We anticipate that our existing cash and cash equivalents, together with the proceeds of this offering, will be sufficient to fund operations for at least the next 12 months. We expect that the net proceeds of this offering of \$10,200,000, based on an assumed public offering price of \$4.00 per share, which is the minimum price necessary for listing on the Nasdaq Capital Market, will be adequate to fund our operations for approximately the next 9 quarters (27 months) based on our projected monthly requirement of approximately \$800,000. Our current cash requirement to fund our operations is approximately \$350,000 per month. We anticipate our projected monthly requirements to increase significantly due to the following:

- Increase in the number of employees
- Increase in sales, marketing, engineering and administrative expenses
- Increase in legal expenses

To obtain additional capital when needed, we will 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 under development or that our products, if successfully developed, will generate revenues sufficient to enable us to earn a profit. If we are unable to obtain additional capital, management may be required to explore alternatives to reduce cash used by operating activities, including the termination of development efforts that may appear to be promising, the sale of certain assets, possibly including our patent portfolio, and the reduction in overall operating activities.

**Off Balance Sheet Arrangements**

At June 30, 2007, VimetX did not have any off-balance-sheet arrangements except for operating lease commitments discussed in the notes to the financial statements.

## BUSINESS

### Corporate Overview and History

Our predecessor corporation was incorporated in the State of California in November 1992. We were incorporated in the State of Delaware in April 2007 and on May 30, 2007 we filed a certificate of merger in Delaware pursuant to which we changed our domicile from California to Delaware. On October 29, 2007, we changed our name from PASW, Inc. to VirnetX Holding Corporation. From our inception until January 2003, we were engaged in the business of developing and licensing software that enabled internet and web based communications. As of January 31, 2003, we sold all of our operating assets, and since such time our only source of revenue has been derived from nominal royalties payable to our wholly-owned Japan subsidiary, Network Research Corp. Japan, Ltd. pursuant to the terms of a single license agreement. In addition to our Japan subsidiary, we have three other wholly-owned subsidiaries, two of which are California corporations and the other of which is incorporated under the laws of the United Kingdom. These other subsidiaries are currently inactive. We have had substantially no day to day operations since we sold all of our operating assets on January 31, 2003. We acquired VirnetX as a wholly-owned subsidiary on July 5, 2007 and ceased being a shell company. Additionally, pursuant to the merger with VirnetX, we experienced a change in control, with the former securityholders of VirnetX acquiring control of VirnetX Holding Corporation.

VirnetX was incorporated in the State of Delaware in August 2005. It is a development stage company that was formed to commercialize a patent portfolio for providing solutions for secure real-time communications such as instant messaging, or "IM," and voice over internet protocol, or "VoIP." VirnetX acquired certain patents from Science Applications International Corporation, a systems, solutions and technical services company based in San Diego, California (better known as "SAIC") and in February 2007 commenced a lawsuit against Microsoft Corporation alleging infringement of three of our patents.

### Principal Products and Services

#### *Technology and Solutions Business*

Our primary strategy for our technology and solutions business is to commercialize our patented technology in the area of secure real-time communication. We are developing technology for:

- "single-click" and "zero-click" security solutions for real-time communications; and
- "end-to-end" security for VoIP, video conferencing and other types of peer-to-peer collaboration without degradation in quality of service.

In addition, we expect to continue to generate nominal royalties payable to our Japan subsidiary pursuant to the terms of a single license agreement. This license agreement was entered into in 1994 and, pursuant to its terms, it automatically renews on an annual basis unless either party terminates as a result of a breach by the other party or the licensee going out of business.

#### *Contract Services Business*

Our primary strategy for our contract services business is to leverage our research and development group to provide contract research, prototyping, systems integration and technical services to numerous branches of the U.S. Federal government, network service providers and other OEM partners. Our team is staffed with nationally accredited scientists who have experience with research and development projects concerning industry-wide security solutions as well as national security. We intend to provide these contract services to assist the research and development efforts of our corporate and OEM developers by providing outsourced research, deployment and testing services designed to secure and simplify networks.

We believe that the revenue generated by our contract services business will eventually partially offset the costs of our technology and solutions business and will provide us with the opportunity to generate future strategic relationships and licensing opportunities. We also anticipate that future contract services projects will enable us to develop promising new technologies that can be commercialized through our technology and solutions business.

### **Marketing and Sales**

We do not anticipate launching any new products in the marketplace until late 2007 at the earliest. We intend to partner with hardware and software manufacturers and network operators to operationalize and commercialize our products.

Our contract services business expects to generate new customers primarily through professional relationships and referrals.

### **Customers and Distribution**

We are a development stage company with significant investments in research and development, and we currently do not sell or distribute any of our products. We expect that our contract services customers will consist primarily of the U.S. Federal government, network service providers and other OEM companies. Our contract services business has targeted five customers who we expect will represent more than 80% of our future contract services revenue for the foreseeable future.

We have made a strategic decision to selectively limit new customers in our contract services business in order to focus on the development of new products in our technology and solutions business.

### **Competition**

The enterprise telephony market has transitioned from being circuit-switched to packet switched in large part to eliminate the requirement of running separate voice and data networks. The IP telephony industry conceived session initiation protocol (better known as "SIP") to improve the setup and handling of telephone calls, and computer technologists have quickly adopted SIP as a protocol to simplify all forms of real-time communications. The rapid market adoption of SIP has created the need to secure SIP before it can reach the global mainstream.

SIP is a growing protocol used for real-time communication, and we anticipate that SIP will represent a significant portion of the worldwide IP telephony market over the next five years. It has become the basis for 'next generation networks' for unified messaging and communication. SIP uses existing protocols and services, including domain name system, or "DNS," real-time transport protocol, or "RTP," the session description protocol, or "SDP," and transport layer security, or "TLS."

A number of vendors are providing solutions for secure real-time communications. These solutions can be grouped under three main categories:

- A session border controller, or "SBC," is a device used in some VoIP networks to exert control over the signaling and media streams involved in setting up, conducting, and tearing down calls. SBCs are put into the signaling and/or media path between the calling and called party. In some cases, the SBC acts as the called VoIP phone and places a second call to the called party. The effect is that the signaling traffic not only crosses the SBC but the media traffic (voice, video etc.) crosses as well. We believe the security provided by SBC is limited because the SBC can extend the length of the media path (the path of media packets through the network) significantly and may break the end-to-end transparency.
- 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 (better known as "NAT") and dynamic firewall functions and support multiple signaling protocols and media transcoding functionality, allowing secure traversal and interconnection of IP media streams across multiple networks.
- VPN technologies provide secure communications over unsecured networks.

We believe our technology and solutions business will compete primarily against these disparate add-on security solution providers. We believe our products will allow our OEM partners to integrate transparent and always on, end-to-end security directly into their unified messaging and communications solutions.

Our contract services business competes primarily against in-house research and development departments of network service providers and other OEM vendors.

## Intellectual Property and Patent Rights

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

We have 10 issued U.S. and 4 issued foreign patents, and pending U.S. and foreign patent applications including certain patent applications which VirnetX originally acquired from SAIC. The term of the issued U.S. and foreign patents runs through 2019. Our patents embrace a unique set of functions relating to domain name system, or "DNS,"-based security mechanisms for real-time communication. If we believe that a third party is infringing on our intellectual property rights, we may negotiate with it in an attempt to terminate its infringement. If negotiation is unsuccessful or if we believe that legal action is more appropriate, we may bring a legal action against any party we believe to be infringing on our intellectual property rights so that we may properly protect our rights.

### Assignment of Patents

Most of our issued patents were originally acquired from SAIC pursuant to the Assignment Agreement by and between VirnetX and SAIC dated December 21, 2006, and the Patent License and Assignment Agreement by and between VirnetX and SAIC dated August 12, 2005, as amended on November 2, 2006, including documents prepared pursuant to the November amendment. VirnetX recorded the assignment from SAIC with the U.S. Patent 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 Office, including, without limitation, the right to sue for past infringement.

*License to SAIC Outside the Field of Use.* 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 application 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 voice over internet protocol (or "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; instant messaging (or "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 (e.g., wire, fiber, wireless, or mixed medium).

*Compensation Obligations.* As consideration for the assignment of the patents, 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 15% of all gross revenues of VirnetX less (i) trade, quantity and cash discounts allowed, (ii) 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 VirnetX's industry, and (iii) 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 shall be no more than \$35,000,000.

- 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 \$35,000,000. Any such acquisition proceeds shall be credited against the \$35,000,000 maximum cumulative royalty payable.
- 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, 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 \$35,000,000 maximum cumulative royalty payable.
- 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, 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 \$35,000,000 maximum cumulative royalty payable.

*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 \$7,500,000 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;
- for the period prior to the date of our full payment of the \$35,000,000 maximum cumulative royalty, any breach by us of our license to SAIC outside our field of use that has not been cured within 30 days after our receipt of notice of such failure; or
- for the period prior to the date of our full payment of the \$35,000,000 maximum cumulative royalty, any termination of the August agreement with SAIC, as amended.

If a reversion event occurs due to our failure to pay SAIC an aggregate cumulative amount of at least \$7,500,000 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 right to bring and control any action or proceeding with respect to infringement or enforcement of our patents in 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, provided, however, that we have such right to negotiate with or bring a lawsuit against certain alleged infringing companies up to and through November 2, 2007.

*Security Agreement.* We granted SAIC a security interest in some of our intellectual property, including the patents and patent applications we obtained from SAIC patents, to secure our payment obligations to SAIC described above.

## **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.

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 the Company.

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 prospectus.

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.

## **Research and Development**

We are currently involved in basic research at our office located in Scotts Valley, California and through personnel based in Sterling, Virginia. We are focused on developing new techniques for automatic and transparent real-time communication security. We have invested approximately \$56,000 in 2005, \$554,187 in 2006 and \$268,178 for the six-month period ended June 30, 2007 on research and development relating to our proposed products.

Additionally, we conduct some of our product development through the use of outsourced development partners. Our current development projects are derived from strategic relationships with other companies. We anticipate developing other new products through a combination of licensing, acquisitions and our discovery research activities.



### **Products in Development**

We intend for our products to be available as object libraries for easy integration into enterprise VoIP, conference calling, IM, file transfer, application sharing, whiteboard, video conference and other real-time collaboration systems solutions.

We currently have two principal products in development:

- The VirnetX Edge Toolkit, which will be designed to allow OEM partners to integrate our proprietary technology into their private branch exchanges (better known as PBXs), call managers and client solutions. We anticipate releasing the first version of the Toolkit product in late 2007.
- The VirnetX Secure Directory Service, which will be designed to provide secure presence and directory services to certified individual domain names based on identity verification and will be designed to enable automatic domain name system, or “DNS,” -triggered certified encrypted connections. We anticipate providing this service to initial customers in 2008.

We intend to commercialize our existing technology by designing, manufacturing and marketing products incorporating our technology and by partnering with other companies whose products incorporate our technology. In addition, we intend to leverage our outstanding team of scientists to continue to develop promising new technologies.

### **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.

### **Employees**

As of October 31, 2007, we had eight full-time employees and one part time employee.

### **Facilities**

Our principal executive offices are located at 5615 Scotts Valley Drive, Suite 110, Scotts Valley, California 95066, which property we lease for \$1,243.75 per month until March 31, 2008. We have no other properties.

**MANAGEMENT**

The following table sets forth the respective names, ages and positions of each of our directors, and executive officers as of October 31, 2007. There are no family relationships between any of the persons named below. All of our directors were elected to the Board of Directors on July 5, 2007, and their terms run until our annual meeting of stockholders in 2008.

Name	Age	Position
<b>Executive Officers and Directors</b>		
Kendall Larsen	50	President, Chief Executive Officer and Director
William E. Sliney	69	Chief Financial Officer (Interim)
Edmund C. Munger	63	Director
Scott C. Taylor	43	Director
Michael F. Angelo	47	Director
Thomas M. O'Brien	41	Director

*Kendall Larsen.* Mr. Larsen has been our President, Chief Executive Officer and a director since July 5, 2007 and has held the same positions with VirnetX since its inception in August 2005. From April 2003 to July 2005, Mr. Larsen focused on pre-incorporation activities related to VirnetX. From April 2002 to April 2003, Mr. Larsen was a Limited Partner at Osprey Ventures, L.P., a venture fund that makes investments primarily in business and consumer technology companies. From October 2000 to April 2002, he was Senior Vice President and General Manager of the Security Products Division of Phoenix Technologies Ltd., a software and firmware developer. Prior to March 2003, and for a period of over 20 years, Mr. Larsen has held senior executive positions at various leading technology companies, including RSA Security, Inc., Xerox Corporation, Rolm/International Business Machines Corporation, Novell, Inc., General Magic, Inc., and Ramp Networks. Mr. Larsen holds a B.S. in Economics from the University of Utah.

*William E. Sliney.* Mr. Sliney has been our Chief Financial Officer on an interim and part-time basis since July 5, 2007. Prior to that time, Mr. Sliney served as our President from August 2001, Chief Financial Officer from April 1999 and Secretary from December 2001. He also served as our Chairman of the Board from October 2000 to August 2001 and was a member of our Board of Directors from October 2000 to July 5, 2007. He was also a director of Enterra Energy Trust (NYSE: ENT), an oil and gas trust based in Calgary, Alberta that acquires, operates, and exploits petroleum and natural gas assets in Canada and in the United States, from January 2002 to March 2006. Before joining us, Mr. Sliney was the Chief Financial Officer of Legacy Software Inc. from 1995 to 1998. From 1993 to 1994, Mr. Sliney was Chief Executive Officer of Gump's, a high end department store retailer based in San Francisco. Mr. Sliney received an M.B.A. from the Anderson School at UCLA.

*Edmund C. Munger.* Mr. Munger has been a director since July 5, 2007. He has been the Chief Technology Officer of VirnetX since July 2006 and a director of VirnetX since August 2006. From July 1987 to June 2006, Mr. Munger held various positions including Associate Division Manager, Division Manager, Chief System Architect and Assistant Vice President at Science Applications International Corporation ("SAIC") (NYSE: SAI), a leading provider of services and solutions to all branches of the U.S. military, agencies of the Department of Defense, the intelligence community, the U.S. Department of Homeland Security and other U.S. government civil agencies, as well as to customers in selected commercial markets. Mr. Munger is named as a co-inventor on all patents in the VirnetX patent portfolio. Mr. Munger received a M.S. in Naval Architecture and Marine Engineering from MIT and a B.S. in Naval Science from the United States Naval Academy.

*Thomas M. O'Brien.* Mr. O'Brien has been a director since July 5, 2007. He has been Senior Vice President of Reit Management & Research LLC, an institutional manager of real estate, public real estate investment trusts ("REITs") and other public companies, since May 2006 and served as a Vice President of that company from May 1996 to April 2006. During the last five years, Mr. O'Brien has held various positions with public entities managed by Reit Management or its affiliates, including serving as: (i) Chief Executive Officer and President of TravelCenters of America LLC (AMEX: TA), since February 2007 and a Managing Director since October 2006; (ii) Chief Executive Officer and President of RMR Funds, a group of publicly traded closed-end investment management companies which invest in equity and fixed income securities in the U.S. and international real estate, hospitality

and finance sectors, from 2003 to May 2007; and (iii) Executive Vice President of Hospitality Properties Trust (NYSE: HPT), a REIT that invests in hotels and travel centers, from 2002 to 2003 and Chief Financial Officer from 1996 to 2002. From 1988 to 1996, Mr. O'Brien was a senior manager with Arthur Andersen LLP where he served a number of public company clients. Mr. O'Brien graduated cum laude from the University of Pennsylvania, Wharton School of Business, with a B.S. in Economics.

*Michael F. Angelo.* Mr. Angelo has been a director since July 5, 2007. He has been a Senior Architect at NetIQ Corporation since August 2005. From October 2003 to August 2005, Mr. Angelo was a Security Architect and Manager, Government Engagements SBU with Microsoft Corporation. From July 1989 to October 2003, Mr. Angelo was a Staff Fellow at both Hewlett Packard Company and Compaq Computer Corp. Mr. Angelo also served as Senior Systems Programmer at the John von Neumann National Supercomputer Center from September 1985 to July 1989. He was a Sub-Chairman of the National Institute of Standards and Technology Board of Assessment for Programs/National Research Council responsible for the CISO review, for fiscal years 2000-2001 and 2001-2002 fiscal years, and a technology contributor and participant on the U.S. Commerce Department's Information Systems Technical Advisory Council (ISTAC), from 1999 to the present. Mr. Angelo was named a distinguished lecturer for 2004 and 2005 by Sigma XI, the Scientific Research Society. He currently holds 49 patents, most in the area of security and authentication, and was also named the 2003 Inventor of the Year for the City of Houston by the Houston Intellectual Property Lawyers Association.

*Scott C. Taylor.* Mr. Taylor has been a director since July 5, 2007. Mr. Taylor has been the Vice President, Corporate Legal Services for Symantec Corporation (NASDAQ: SYMC), the global leader in consumer and enterprise security and availability software solutions, since February 2007. From January 2002 to February 2007, Mr. Taylor worked for Phoenix Technologies Ltd, a public (NASDAQ: PTEC) software and firmware company. Prior to 2002, Mr. Taylor has worked at Narus Inc, Symantec Corporation, Pillsbury Madison & Sutro LLP (now Pillsbury Winthrop Shaw Pittman LLP), ICF Incorporated (now ICF Consulting) and the U.S. Securities and Exchange Commission in various roles. Mr. Taylor has been admitted to practice law in the State of California since 1993 and is an advisory Board Member at Langtech (IT infrastructure consulting and outsourced management). He is the Co-chair of General Counsel Committee (and former board member) of the Silicon Valley Campaign for Legal Services and maintains a Top Secret security clearance with the U.S. government. Mr. Taylor has a B.A. in International Relations from Stanford University and a J.D. from George Washington University.

#### **Significant Employees**

*Robert Dunham Short III.* Mr. Short has been the Chief Scientist for VirnetX since May 2007. From February 2000 to April 2007, Mr. Short was Assistant Vice President and Division Manager at Science Applications International Corporation ("SAIC") (NYSE: SAI), a leading provider of services and solutions to all branches of the U.S. military, agencies of the Department of Defense, the intelligence community, the U.S. Department of Homeland Security and other U.S. government civil agencies, as well as to customers in selected commercial markets. From 1994 to February 2000, he also held various other positions at SAIC. Prior to SAIC, he has also worked at ARCO Power Technologies, Inc. (Atlantic Richfield Petroleum), Sperry Corporate Technology Center and Sperry Research Center. Mr. Short is named as a co-inventor on all the patents in the VirnetX patent portfolio. He holds a TS/SCI security clearance. He has a Ph.D in Electrical Engineering from Purdue University along with a M.S. in Mathematics and a B.S. in Electrical Engineering from Virginia Tech.

*Kathleen Sheehan.* Ms. Sheehan has been the Vice President, Administration and Human Resources for VirnetX since December 2005. Ms. Sheehan was also the Treasurer and Chief Financial Officer of VirnetX from March 2006 until July 5, 2007. From September 2004 to July 2005, Ms. Sheehan focused on equity raise and pre-incorporation activities related to VirnetX. From September 2002 to September 2004, Ms. Sheehan was a Commercial Property Manager for JBD Properties, a real estate developer. Prior to September 2002, she worked for Armen and Associates as an Executive Recruiter. She has also worked at CHW Advertising (Senior Director of Human Resources), Modis/SAP (Human Resources and Office Manager) and as an executive recruiter for top level executives in the e-commerce & advertising industry.

*Sameer Mathur.* Mr. Mathur has been the Vice President, Corporate Development and Marketing for VirnetX since July 5, 2007. Prior to that date, Mr. Mathur was the Vice President, Business Development of VirnetX since

April 2006. From March 2004 to April 2006, Mr. Mathur was Product Line Manager for SonicWALL Inc (NASDAQ: SNWL), a leading provider of Internet security solutions. From April 2003 to March 2004, Mr. Mathur was Senior Product Manager for Zone Labs Inc, a leading provider of Internet security software. From June 1996 to April 2003, he was Senior Product Marketing Manager of Phoenix Technologies Ltd, a public (NASDAQ: PTEC) software and firmware company. Prior to June 1996, Mr. Mathur has worked in various engineering and marketing roles for OEC Japan, IBM Japan, Peritech Computers Ltd. Mr. Mathur has a B.S. in Engineering from Gujarat University, India.

## COMPENSATION DISCUSSION AND ANALYSIS

### Overview

The goals of our executive compensation program are to attract, retain, motivate and reward executive officers who contribute to our success and to incentivize these executives on both a short-term and long-term basis to achieve our business objectives. This program combines cash and equity awards in the proportions that we believe will motivate our executive officers to increase shareholder value over the long-term.

Our executive compensation program is designed to achieve the following objectives:

- align our executive compensation with our strategic business objectives;
- align the interests of our executive officers with both short-term and long-term shareholder interests; and
- place a substantial portion of our executives' compensation at risk such that payouts depend on both overall company performance and individual performance.

### Executive Compensation Program Objectives and Framework

Our executive compensation program has two primary components: (1) base salary, and (2) equity grants. Base salaries for our executive officers are a minimum fixed level of compensation consistent with or below competitive market practice. Equity grants awarded to our executive officers are designed to ensure that incentive compensation is linked to our long-term company performance, promote retention and align our executives' long-term interests with shareholders' long-term interests.

Executive compensation is reviewed annually by our Board of Directors, and adjustments are made to reflect company objectives and competitive conditions.

### Role of Our Compensation Committee

Our Compensation Committee, made up of independent directors of the Board of Directors, oversees the Company's executive compensation program. In this capacity, the individual directors review compensation levels of executive officers, evaluate performance of executive officers, and consider management succession and related matters.

### Current Executive Compensation Program Elements

Our executive compensation program consists of the elements described in the following sections. The Compensation Committee determines the portion of compensation allocated to each element for each individual executive officer. Our Compensation Committee expects to continue these policies in the short-term but will reevaluate the current policies and practices as it considers advisable.

The Compensation Committee believes based on their general business and industry experience and knowledge that the use of the combination of base salary and long-term incentives (including stock option or other stock-based awards) offers the best approach to achieving our compensation goals, including attracting and retaining talented and capable executives and motivating our executives and other officers to expend maximum effort to improve the business results, earnings and overall value of our business.

***Base Salaries***

Base salaries for our executive officers are established based on the scope of their responsibilities, taking into account competitive market compensation for similar positions, as well as seniority of the individual, our ability to replace the individual and other primarily judgmental factors deemed relevant by the Compensation Committee. Generally, we believe that executive base salaries should be targeted near the median of the range of salaries for executives in similar positions with similar responsibilities at comparable companies, in line with our compensation philosophy. Base salaries for our executive officers are reviewed annually or at other appropriate times by the Compensation Committee and may be increased from time to time pursuant to such review and/or in accordance with guidelines contained in the various employment agreements in order to realign salaries with market levels after taking into account individual responsibilities, performance and experience.

***Long-term Incentive Equity Awards***

Our Board of Directors has adopted the VirnetX 2005 Stock Plan, which provides for the grant of incentive stock options (within the meaning of Section 422 of the Internal Revenue Code) and non-qualified stock options to eligible employees and consultants of the Company and non-employee directors of the Company. We intend to seek the approval of our stockholders for the adoption of the VirnetX 2005 Stock Plan by written consent of our stockholders, which we expect to occur within the next three months, but in no event will it occur later than July 4, 2008.

***Policy with Respect to Section 162(m)***

Section 162(m) of the Internal Revenue Code generally disallows public companies from utilizing a tax deduction for compensation in excess of \$1,000,000 paid to their chief executive officers and the four other most highly compensated executive officers unless certain performance and other requirements are met. Our intent generally is to design and administer executive compensation programs in a manner that will preserve the deductibility of compensation paid to our executive officers, and we believe that a substantial portion of our current executive compensation program (including the stock options and other awards that may be granted to our executive officers as described above) satisfies the requirements for exemption from the \$1,000,000 deduction limitation. However, we reserve the right to design programs that recognize a full range of performance criteria important to our success, even where the compensation paid under such programs may not be deductible. The Board of Directors will continue to monitor the tax and other consequences of our executive compensation program as part of its primary objective of ensuring that compensation paid to our executive officers is reasonable, performance-based and consistent with the goals of the Company and its stockholders.

**Compensation of VirnetX Holding Corporation Executive Officers and Directors**

**Summary Compensation**

For the three most recently completed fiscal years, no compensation was paid to any executive officer of VirnetX Holding Corporation. Between February and May 2007, William E. Sliney received \$30,000 for his services as President, Chief Financial Officer and Secretary of VirnetX Holding Corporation.

**Outstanding Equity Awards at Fiscal Year End**

None of the VirnetX Holding Corporation executive officers held any options or other equity awards at December 31, 2006.

**Director Compensation**

None of the VirnetX Holding Corporation directors received any compensation for service as a director of VirnetX Holding Corporation during the fiscal year ended December 31, 2006.

**Employment Contracts**

None of the VirnetX Holding Corporation executive officers has an employment agreement with VirnetX Holding Corporation. VirnetX Holding Corporation intends to enter into an employment agreement with each of its key employees.

**Compensation of VirnetX Executive Officers and Directors**

**Summary Compensation Table**

In connection with the consummation of the merger with VirnetX, VirnetX's President and Chief Executive Officer, Kendall Larsen, became the President and Chief Executive Officer of VirnetX Holding Corporation. In addition, Mr. Sliney, who served until July 5, 2007 as VirnetX Holding Corporation's President (from August 2001), Chief Financial Officer (from April 1999), Secretary (from December 2001), and member of VirnetX Holding Corporation's Board of Directors (from October 2000), will continue as our Chief Financial Officer on an interim basis. The following table sets forth the compensation paid for services rendered to VirnetX since inception by its President and Chief Executive Officer. There were no other executive officers during the two fiscal years ended December 31, 2006. All information relating to option awards reflects the exchange of VirnetX options for VirnetX Holding Corporation options in the merger.

Name and Principal Position	Year	Salary (\$)	Bonus (\$)	Stock Awards (\$)	Option Awards (\$)	Non-Equity Incentive Plan Compensation (\$)	All Other Compensation (\$)	Total (\$)
Kendall Larsen President and Chief Executive Officer	2006	\$237,039	—	—	\$7,665	—	—	\$244,704
	2005(1)	—	—	—	—	—	\$399,960(2)	\$399,960

(1) From inception of VirnetX in August 2005 until December 31, 2005.

(2) Represents the dollar value of stock grants to Mr. Larsen during the period.

**Outstanding Equity Awards at Fiscal Year End**

The following table provides information as to options held by each of the executive officers of VirnetX at December 31, 2006. The figures set forth in the table reflect the exchange of VirnetX options for VirnetX Holding Corporation options pursuant to the merger on a post-split basis.

Name	Option Awards					Stock Awards			
	Number of Securities Underlying Unexercised Options (#) Exercisable	Number of Securities Underlying Unexercised Options (#) Unexercisable	Equity Incentive Plan Awards: Number of Securities Underlying Unexercised Unearned Options (#)	Option Exercise Price (\$)	Option Expiration Date	Number of Shares or Units of Stock That Have Not Vested (#)	Market Value of Shares or Units of Stock That Have Not Vested (#)	Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights That Have Not Vested (#)	Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested (\$)
Kendall Larsen	41,516	0	—	\$0.24087	March 22, 2016	—	—	—	—

On March 3, 2006, Kendall Larsen was granted VirnetX options, which were exchanged for fully-vested VirnetX Holding Corporation options to purchase 41,516 post-split shares of our common stock at an exercise price of \$0.24087 per post-split share pursuant to the merger. In addition, Mr. Larsen held restricted shares of VirnetX common stock, purchased at \$0.0003 per post-split share on October 14, 2005, all of which are fully vested, which were exchanged for 1,660,638 post-split shares of our common stock pursuant to the merger. Neither VirnetX nor VirnetX Holding Corporation has granted plan-based awards to any executive officers in fiscal 2007.

**Director Compensation**

VirnetX has historically not paid any of its directors for their services as directors. We intend to compensate our non-employee directors at competitive rates.

**Employment Contracts**

VirnetX intends to enter into employment agreements with each of its key employees.

**Equity Incentive Plans**

On April 17, 1998, 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 reserved for issuance under this program is 150,580 post-split shares. As of December 31, 2006, there were no outstanding options or rights under this program. In connection with the merger between VirnetX Holding Corporation and VirnetX, we assumed and our Board of Directors has adopted the VirnetX 2005 Stock Plan as amended to cover awards of shares of our common stock. The total number of shares of our common stock reserved for issuance under the VirnetX Plan is 11,624,469, of which as of October 31, 2007, there were 4,028,418 shares remaining available for future grants. We intend to seek the approval of our stockholders for the adoption of the VirnetX Plan by written consent of our stockholders, which is expected to occur within the next three months, but in no event will it occur later than July 4, 2008.

**CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS  
AND CORPORATE GOVERNANCE**

In connection with the consummation of the merger between VirnetX Holding Corporation and VirnetX, we assumed certain obligations under an Advisory Service Agreement dated November 6, 2006 by and between VirnetX and MDB Capital Group LLC, as amended by the terms of that certain Release Agreement between the same parties, which was executed on July 5, 2007. MDB Capital Group was a stockholder of VirnetX prior to the merger and Christopher Marlett, a principal at MDB Capital Group, is currently one of our stockholders as a result of the merger. Christopher Marlett, as of July 5, 2007, beneficially owned approximately 6.7% of our issued and outstanding shares of common stock. MDB Capital Group's affiliates include Anthony DiGiandomenico and Robert Levande, each of whom is one of our existing stockholders as a result of the merger.

Additionally, in connection with the consummation of the merger, we entered into the following agreements and transactions with certain of our directors, executive officers and 5% stockholders:

**Indemnification Agreements**

We entered into Indemnification Agreements with each person who became one of VirnetX Holding Corporation's directors or officers in connection with the consummation of the merger, pursuant to which, among other things, we will indemnify such directors and officers to the fullest extent permitted by Delaware law, and provide for advancement of legal expenses under certain circumstances.

**Registration Rights Agreement**

Effective as of July 5, 2007, we entered into a Registration Rights Agreement with all of the persons who were issued shares of our common stock and securities convertible into shares of our common stock in the merger.

Pursuant to the Registration Rights Agreement, commencing six months after the closing of the merger, the securityholders have a right to request that we register for resale (a) the shares of common stock issued to such persons in the merger and (b) the shares of common stock underlying convertible notes, options and warrants issued to such persons in the merger. We are required to cause each such registration statement filed as a result of such requests to be declared effective under the Securities Act as promptly as possible after the filing thereof and to keep such registration statement continuously effective under the Securities Act until the earlier of (i) the date when all shares included in the registration statement have been sold; (ii) the date that all of shares can be sold pursuant to Rule 144; and (iii) one year from the effective date of such registration statement. In addition, the San Gabriel group of investors have the right to have their 5,333,333 shares registered for resale on the registration statement filed with respect to this offering.

Additionally, the Registration Rights Agreement provides the securityholders with "piggyback" registration rights such that at any time there is not an effective registration statement covering the common stock described above and we file a registration statement relating to an offering for our own account or the account of others under the Securities Act, other than in connection with any acquisition of any entity or business or equity securities issuable in connection with stock options or other employee benefit plans and other than in connection with this offering, then we are required to send notice to the securityholders of such intended filing at least 20 days prior to filing such registration statement and we are required to automatically include in such registration statement all shares of common stock issued in the merger and all shares of common stock underlying convertible notes, options and warrants issued in the merger.

Each securityholder also has indemnified us, our directors, officers, agents, and certain other control persons against damages arising out of or based upon: (i) such securityholder's failure to comply with the prospectus delivery requirements of the Securities Act or (ii) such securityholder's provision of any untrue or alleged untrue statement of a material fact to be contained in any registration statement or prospectus, or arising out of or relating to any such securityholder's omission or alleged omission of a material fact required to be stated therein or necessary to make the statements contained in such registration statement or prospectus not misleading.



**Lock-Up Agreements**

Effective as of July 5, 2007, we entered into a Lock-Up Agreement with certain of the persons who were issued shares of our common stock in the merger and all persons who exchanged VirnetX options for VirnetX Holding Corporation options in the merger, pursuant to which we imposed certain restrictions on the sale of our common stock or any securities convertible into or which may be exercised to purchase any shares of our common stock acquired in connection with the merger for a period of at least 12 months after the consummation of the merger; provided that the lockup period may be extended under certain circumstances. In addition, all of our officers and directors, as well as those stockholders listed in the resale prospectus filed with this registration statement have entered into a Lock-Up Agreement with the underwriter for a period commencing on the date hereof and ending 12 months from the effective date of the registration statement; provided, however, that if the average closing price per share of the Company's common stock exceeds 150% of the public offering price of the shares to be offered for 15 consecutive trading days during the lock-up period, the shares of common stock held by the San Gabriel group of investors shall be released from the lock-up by our underwriter. The San Gabriel group of investors owns 5,333,333 shares of our common stock that are subject to this release provision.

**Transactions Between the Company and William E. Sliney**

Until July 5, 2007, the Company utilized the office space and equipment of its then officer, William E. Sliney, at no cost. Management estimates the value thereof to be immaterial.

**Promoters and Control Persons**

Glenn Russell was a founder and owned approximately 60% of the outstanding shares of VirnetX Holding Corporation immediately prior to the merger between VirnetX Holding Corporation and VirnetX. Mr. Russell received no compensation in connection with the merger between VirnetX and VirnetX Holding Corporation. Mr. Russell's historical compensation from VirnetX Holding Corporation in his capacity as its Chief Executive Officer prior to the merger has been disclosed in VirnetX Holding Corporation's reports filed with the SEC under the Securities Exchange Act of 1934, as amended.

**Director Independence**

Three members of the Board of Directors, Scott C. Taylor, Michael F. Angelo and Thomas M. O'Brien, qualify as "independent" directors under the definition of "independent director" in the listing standards of The Nasdaq Stock Market, Inc. -Marketplace Rule 4200, so that a majority of the members of our Board are "independent." Although our securities are not currently traded on a national securities exchange that would require a majority of our directors to be "independent," we intend to comply with the independence provisions on a voluntary basis.

## DESCRIPTION OF SECURITIES

On a post-split basis, we are authorized to issue an aggregate of 110,000,000 shares of capital stock, 100,000,000 of which are shares of common stock, par value \$0.0001 per share, and 10,000,000 of which are shares of preferred stock, par value \$0.0001 per share. As of October 31, 2007, on a post-split basis, 31,217,198 shares of our common stock were issued and outstanding and no shares of our preferred stock were issued and outstanding.

### Common Stock

All outstanding shares of our common stock are of the same class and have equal rights and attributes.

*Voting.* The holders of our common stock are entitled to one vote per share on all matters submitted to a vote of stockholders. Our common stock does not have cumulative voting rights. Persons who hold a majority of the outstanding shares of our common stock entitled to vote on the election of directors can elect all of the directors who are eligible for election.

*Dividends.* Subject to the preferential dividend rights and consent rights of any series of preferred stock that we may from time to time designate, holders of our common stock are entitled to share equally in dividends, if any, as may be declared from time to time by our Board of Directors out of funds legally available.

*Liquidation and Dissolution.* In the event of our liquidation, dissolution or winding up, subject to the preferential liquidation rights of any series of preferred stock that we may from time to time designate, the holders of our common stock are entitled to share ratably in all of our assets remaining after payment of all liabilities and preferential liquidation rights.

### Preferred Stock

Our Certificate of Incorporation authorizes the issuance of shares of preferred stock with designations, rights and preferences determined from time to time by our Board of Directors. Accordingly, our Board of Directors is empowered, without stockholder approval, to issue preferred stock with dividend, liquidation, conversion, voting, or other rights which could adversely affect the voting power or other rights of the holders of the common stock. In the event of issuance, the preferred stock could be utilized, under certain circumstances, as a method of discouraging, delaying or preventing a change in control of the Company.

The descriptions of our common stock and preferred stock above are only summaries and are qualified in their entirety by the provisions of the Company's Certificate of Incorporation and By-Laws, copies of which are attached or referenced as exhibits to the registration statement of which this prospectus forms a part.

### Warrants

On a post-split basis, warrants for the issuance of up to 266,667 shares of our common stock are outstanding, all of which are exercisable at a price of \$0.75 per share, and all of which are subject to the Lock-Up Agreement described above. These warrants are exercisable for a period of five years beginning on July 5, 2007 and may be exercised on a cashless exercise basis. These warrants provide for anti-dilution protection in the event of stock splits and dividends.

In addition, on a post-split basis, we will issue warrants for the issuance of up to 300,000 shares of our common stock to the underwriter with respect to this offering, with an exercise price equal to the 120% of the price to public in this offering. These warrants are exercisable for a period commencing on the first anniversary of the closing of this offering and for a period of four years thereafter. These warrants provide for anti-dilution protection in the event of stock splits and dividends. The shares of common stock underlying these warrants are being registered in the registration statement of which this prospectus forms a part.

The descriptions of the warrants are only a summary and are qualified in their entirety by the provisions of the forms of warrant, which are attached or referenced as exhibits to the registration statement of which this prospectus forms a part.

**Transfer agent and registrar**

The transfer agent and registrar for our common stock is Corporate Stock Transfer, Inc. of Denver, Colorado.

**MARKET PRICE OF AND DIVIDENDS ON COMMON EQUITY  
AND RELATED STOCKHOLDER MATTERS****Market Information**

Our common stock is traded in the over-the-counter market on the Nasdaq OTC Bulletin Board under the symbol "VNXH." The following table shows the price range of our common stock for each quarter ended during the last two fiscal years and for the first three quarters of fiscal 2007 on a post-split basis.

<u>Quarter Ended</u>	<u>High</u>	<u>Low</u>
3/31/05	\$ 0.36	\$ 0.24
6/30/05	\$ 0.36	\$ 0.30
9/30/05	\$ 0.60	\$ 0.39
12/31/05	\$ 0.42	\$ 0.30
3/31/06	\$ 0.60	\$ 0.36
6/30/06	\$ 0.54	\$ 0.21
9/30/06	\$ 0.51	\$ 0.30
12/31/06	\$ 0.87	\$ 0.36
3/31/07	\$ 5.10	\$ 0.75
6/30/07	\$ 4.65	\$ 3.75
9/30/07	\$ 4.89	\$ 3.96

On October 30, 2007, on a post-split basis, the average of the high ask and low bid prices, respectively, of our common stock as reported on the OTC Bulletin Board, was \$5.05 per share. The source of the information provided in the table above is the OTC Bulletin Board®, *Quarterly Trade and Quote Summary Report*, and represents prices between dealers without adjustments for retail markups, markdowns or commissions, and may not represent actual transactions.

**Holders**

As of October 1, 2007, there were approximately 97 holders of record of our common stock.

**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, 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 reserved for issuance under this program is 150,580 shares post-split. As of December 31, 2006, there were no outstanding options or rights under this program. In connection with the merger between VirnetX Holding Corporation and VirnetX, we assumed and our Board of Directors has adopted the VirnetX 2005 Stock Plan as amended to cover awards of shares of our common stock. The total number

of shares of our common stock reserved for issuance under the VirnetX Plan is 11,624,469, of which as of October 31, 2007, there were 4,028,418 shares remaining available for future grants. We intend to seek the approval of our stockholders for the adoption of the VirnetX Plan by written consent of our stockholders, which is expected to occur within the next three months, but in no event will it be held later than July 4, 2008.

#### 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 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.

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 the Company.

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 prospectus.

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.

## INDEMNIFICATION OF OFFICERS AND DIRECTORS

Section 145 of the Delaware General Corporation Law provides that a corporation may indemnify directors and officers as well as other employees and individuals against expenses including attorneys' fees, judgments, fines and amounts paid in settlement in connection with various actions, suits or proceedings, whether civil, criminal, administrative or investigative other than an action by or in the right of the corporation, a derivative action, if they acted in good faith and in a manner they reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, if they had no reasonable cause to believe their conduct was unlawful. A similar standard is applicable in the case of derivative actions, except that indemnification only extends to expenses including attorneys' fees incurred in connection with the defense or settlement of such actions, and the statute requires court approval before there can be any indemnification where the person seeking indemnification has been found liable to the corporation. The statute provides that it is not exclusive of other indemnification that may be granted by a corporation's certificate of incorporation, bylaws, agreement, a vote of stockholders or disinterested directors or otherwise.

Our Certificate of Incorporation provides that we will indemnify and hold harmless, to the fullest extent permitted by Section 145 of the Delaware General Corporation Law, as amended from time to time, each person that such section grants us the power to indemnify.

The Delaware General Corporation Law permits a corporation to provide in its certificate of incorporation that a director of the corporation shall not be personally liable to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, except for liability for:

- any breach of the director's duty of loyalty to the corporation or its stockholders;
- acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;
- payments of unlawful dividends or unlawful stock repurchases or redemptions; or
- any transaction from which the director derived an improper personal benefit.

Our Certificate of Incorporation provides that, to the fullest extent permitted by applicable law, none of our directors will be personally liable to us or our stockholders for monetary damages for breach of fiduciary duty as a director. Any repeal or modification of this provision will be prospective only and will not adversely affect any limitation, right or protection of a director of our company existing at the time of such repeal or modification.

**PRINCIPAL STOCKHOLDERS**

The following table sets forth certain information known to us with respect to the beneficial ownership (as defined in Instruction 4 to Item 403 of Regulation S-B under the Securities Exchange Act of 1934) of our common stock as of October 31, 2007, on a post-split basis, by (i) each person who is known by us to be the beneficial owner of more than 5% of any class of our voting securities, (ii) each of our directors and executive officers, and (iii) all of our executive officers and directors as a group.

Except as indicated by footnote, and subject to applicable community property laws, each person identified in the table possesses sole voting and investment power with respect to all capital stock shown to be held by that person. The address of each executive officer and director, unless indicated otherwise by footnote, is c/o Kendall Larsen, 5615 Scotts Valley Drive, Suite 110, Scotts Valley, California 95066.

Name and Address of Beneficial Owner	Number of Shares Beneficially Owned(1)	Percent of Class(2)
<b>5% or Greater Stockholders:</b>		
Gregory H. Bailey 4 A Chesham Street London, United Kingdom SW1X8DT	2,275,075	7.3%
Kendall Larsen	8,344,708(3)	26.7%
Robert M. Levande 8 East 67 Street New York, New York 10021	2,084,101(4)	6.7%
Blue Screen LLC 7663 Fisher Island Drive Miami, Florida 33109	1,788,463(5)	5.7%
Christopher A. Marlett 420 Wilshire Boulevard, Suite 1020 Santa Monica, California 90401	2,111,933(6)	6.7%
San Gabriel Fund, LLC 4 Richland Place Pasadena, California 91103	1,600,000(7)	5.1%
<b>Directors and Executive Officers:</b>		
Kendall Larsen	8,344,708(3)	26.7%
Edmund C. Munger	435,856(8)	1.4%
William E. Sliney	166	*
Thomas M. O'Brien	0	*
Michael F. Angelo	41,516	*
Scott C. Taylor	0	*
<b>All directors and executive officers as a group (6 persons):</b>	<b>8,822,246(3)(8)</b>	<b>28.1%</b>

- (1) Beneficial ownership is determined in accordance with the rules of the SEC and generally includes voting or investment power with respect to securities. Shares of common stock subject to options and warrants which are exercisable or convertible at or within 60 days of October 31, 2007 are deemed outstanding for computing the percentage of the person holding such option or warrant but are not deemed outstanding for computing the percentage of any other person. The indication herein that shares are beneficially owned is not an admission on the part of the listed stockholder that he, she or it is or will be a direct or indirect beneficial owner of those shares.
- (2) Based upon 31,217,198 shares of common stock issued and outstanding.
- (3) Includes 41,516 shares issuable pursuant to options exercisable within 60 days.
- (4) Includes 207,580 shares held by the Arthur Brown Trust FBO Carolyn Brown Levande.
- (5) Includes 130,893 shares held by Benjamin Lewin directly who has voting and investment power with respect to the shares held by Blue Screen LLC.
- (6) Includes 119,167 shares issuable pursuant to warrants directly held by Christopher A. Marlett exercisable within 60 days and 1,992,766 shares held by the Christopher A. Marlett Living Trust.
- (7) Justin Yorke has sole voting and investment authority over the shares held by San Gabriel Fund, LLC and Mr. Yorke also has sole voting and investment authority over an additional 1,200,000 shares of common stock of VirnetX Holding Corporation held by JMW Fund, Inc.
- (8) Includes 367,589 shares issuable pursuant to options exercisable within 60 days.
- (\*) Less than 1%.

**UNDERWRITING**

Subject to the terms and conditions of an underwriting agreement, Gilford Securities Incorporated has agreed to purchase 3,000,000 shares of common stock from us. The underwriting agreement will provide that our underwriter is committed to purchase all shares offered in this offering, other than those covered by the over-allotment option described below. The resale by our stockholders of up to 5,333,333 shares of our common stock and 266,667 shares of our common stock issuable upon conversion of warrants will not be offered for sale through our underwriter but will be registered pursuant to a separate prospectus covering such securities being filed with the SEC simultaneously with the filing of the registration statement of which this prospectus is a part. In the underwriting agreement, our underwriter's obligations are subject to approval of certain legal matters by their counsel, including, without limitation, the authorization and validity of the shares, and of various other customary conditions, representations and warranties contained in the underwriting agreement, such as receipt by our underwriter of officers' certificates and legal opinions of our counsel.

**Commissions and Discounts**

Our underwriter has advised us that it proposes to offer the shares directly to the public at the price set forth on the cover page of this prospectus, and to certain dealers that are members of the National Association of Securities Dealers, Inc., at such price less a concession not in excess of \$ \_\_\_\_\_ per share. Our underwriter may allow, and the selected dealers may realow, a concession not in excess of \$ \_\_\_\_\_ per share to certain brokers and dealers. After the offering, the offering price and concessions and discounts to brokers and dealers and other selling terms may from time to time be changed by our underwriter.

The following table sets forth the public offering price and underwriting discount to be paid by us to our underwriter and the proceeds, before expenses, to us. This information assumes either no exercise or full exercise by our underwriter of its over-allotment option.

	<u>Per Share</u>	<u>Without Option(1)</u>	<u>With Option</u>
Public offering price	\$	\$	\$
Discount	\$	\$	\$
Non-accountable expense allowance(2)	\$	\$	\$
Proceeds before expenses(3)	\$	\$	\$

- (1) We have granted our underwriter an option, exercisable for 45 days after the date of this prospectus, to purchase a number of shares of common stock equal to 15% of the number of shares sold in this offering by us solely to cover over-allotments, if any, at the same price as the initial shares offered.
- (2) We have agreed to pay our underwriter a non-accountable expense allowance of 3% of the aggregate public offering price of the shares offered (not including upon exercise of the over-allotment option). We have paid our underwriter \$50,000 as an advance against the non-accountable expense allowance. In addition, we have agreed to reimburse our underwriter for its travel, due diligence and road show expenses and expenses incurred by the underwriter's counsel for "Blue Sky" legal fees.
- (3) The offering expenses are estimated to be \$600,000.

**Warrants**

In addition, we have agreed to issue to our underwriter at the closing of this offering, for nominal consideration, warrants to purchase a number of shares of common stock equal to 10% of the number of shares sold in this offering, exclusive of the over-allotment option. These warrants will be exercisable for a four year period commencing on the first anniversary of the closing date of this offering at an exercise price equal to 120% of the price of our common stock offered by this prospectus, or \$ \_\_\_\_\_ per share. These warrants will be restricted from sale, transfer, assignment or hypothecation for a period of one year from the closing of this offering by our underwriter, except to officers of our underwriter and broker-dealers participating in this offering and their bona fide officers and partners, by operation of law or by reason of our reorganization. The NASD views these warrants as

underwriting compensation and requires that the warrants be locked up for 180 days following the effectiveness of this offering pursuant to NASD Conduct Rule 2710 (g)(1).

These warrants contain provisions for appropriate adjustment in the event of any merger, consolidation, recapitalization, reclassification, stock dividend, stock split or similar transaction. The warrants do not entitle our underwriter or a permissible transferee to any rights as a shareholder until the warrants are exercised and shares of our common stock are purchased pursuant to the exercise of the warrants.

These warrants and the shares of our common stock issuable upon their exercise may not be offered for sale except in compliance with the applicable provisions of the Securities Act of 1933, as amended. We are registering the shares of our common stock issuable upon exercise of the warrants in the registration statement of which this prospectus forms a part.

**Electronic Distribution; Directed Share Program**

Our underwriter has advised us that it will not engage in any electronic offer, sale or distribution of our shares. Neither we nor our underwriter will use any third party to host or provide access to our preliminary prospectus on the internet.

We will not have a directed share program for our employees or any others.

**Price Stabilization, Short Positions and Penalty Bids**

Until the distribution of the shares is completed, SEC rules may limit our underwriter from bidding for and purchasing our common stock. In connection with this offering, however, our underwriter may engage in stabilizing transactions, over-allotment transactions, covering transactions and penalty bids in accordance with Regulation M under the Securities Exchange Act of 1934, as amended.

- Stabilizing transactions permit bids to purchase the underlying security so long as the stabilizing bids do not exceed a specified maximum.
- Over-allotment involves sales by our underwriter of shares in excess of the number of shares our underwriter is obligated to purchase, which creates a short position. The short position may be either a covered short position or a naked short position. In a covered short position, the number of shares over-allotted by our underwriter is not greater than the number of shares that it may purchase in the over-allotment option. In a naked short position, the number of shares involved is greater than the number of shares in the over-allotment option. Our underwriter may close out any covered short position by either exercising its over-allotment option or purchasing shares in the open market.
- Covering transactions involve the purchase of common stock in the open market after the distribution has been completed in order to cover short positions. In determining the source of shares to close out the short position, our underwriter will consider, among other things, the price of shares available for purchase in the open market as compared to the price at which it may purchase shares through the over-allotment option. If our underwriter sells more shares than could be covered by the over-allotment option (a naked short position) the position can only be closed out by buying shares in the open market. A naked short position is more likely to be created if our underwriter is concerned that there could be downward pressure on the price of the shares in the open market after pricing that could adversely affect investors who purchase in this offering.
- Penalty bids permit our underwriter to reclaim a selling concession from a selected dealer when the common stock originally sold by the selected dealer is purchased in a stabilizing covering transaction to cover short positions.

These stabilizing transactions, covering transactions and penalty bids may have the effect of raising or maintaining the market price of our common stock or preventing or retarding a decline in the market price of our common stock. As a result, the price of our common stock may be higher than the price that might otherwise exist in the open market. Neither we nor our underwriter makes any prediction or any representation as to the direction or magnitude of any effect that the transactions described above may have on the price of our common stock. Neither we nor our underwriter makes any representation that our underwriter will engage in these transactions. These



transactions may be effected on the American Stock Exchange or otherwise and, if commenced, may be discontinued without notice at any time.

**Lock-Up Arrangements**

We have agreed with our underwriter not to directly or indirectly offer for sale, sell, contract to sell, grant any option for the sale of, or otherwise issue or dispose of, any shares of our common stock, options to acquire common shares or any related security or instrument, for a period of 13 months from the closing of this offering, without the prior written consent of our underwriter, except in limited circumstances.

Our officers and directors who beneficially own 8,822,246 shares of common stock, including 409,105 shares issuable upon exercise of stock options, and all stockholders whose securities are included in the resale prospectus included in this registration statement who own 5,600,000 shares of our common stock (including 266,667 shares of common stock underlying warrants), have agreed with our underwriter not to sell their shares of common stock for 12 months from the closing of this offering without the written consent of our underwriter; provided, however, that if the average closing price per share of the Company's common stock exceeds 150% of the public offering price of the shares to be offered for 15 consecutive trading days during the lock-up period, the shares of common stock held by the San Gabriel group of investors shall be released from the lock-up by our underwriter. The San Gabriel group of investors owns 5,333,333 shares of our common stock that are subject to this release provision. Following the expiration of the lock-up agreement with our underwriter, shares of our common stock held beneficially by our officers and directors will remain subject to holding period restrictions on sale or other transfer under Rule 144 of the Securities Act. The shares registered in the resale prospectus may be immediately sold following the expiration of the lock-up agreement.

Our underwriter has no present intention to waive or shorten the lock-up period. The granting of any waiver of release would be conditioned, in the judgment of our underwriter, on such sale not materially adversely impacting the prevailing trading market for our common stock on the OTC Bulletin Board or the Nasdaq Capital Market, as applicable. Specifically, factors such as average trading volume, recent price trends and the need for additional public float in the market for our common stock would be considered in evaluating such a request to waive or shorten the lockup period.

**Board of Directors Observation Rights**

For a period of three years after the date of this prospectus, our underwriter has the right to appoint an observer reasonably acceptable to us to attend all meetings of our board of directors. We will reimburse this person for expenses incurred in attending any meeting.

**Indemnification**

We have agreed to indemnify our underwriter and its controlling persons against specified liabilities, including liabilities under the Securities Act or to contribute to payments that our underwriter may be required to make for such liabilities. However, we have been advised that in the opinion of the SEC, indemnification for liabilities arising under the Securities Act is against public policy as expressed in the Securities Act and is, therefore, unenforceable.

#### LEGAL MATTERS

The validity of the shares of common stock being offered by this prospectus will be passed upon for us by Orrick, Herrington & Sutcliffe LLP, Menlo Park, California. Lowell Ness, a partner of Orrick, Herrington & Sutcliffe LLP is our Secretary. As of the completion of this offering, Orrick, Herrington & Sutcliffe LLP and partners in that firm beneficially own an aggregate of 124,548 shares of our common stock. Certain matters in connection with this offering will be passed upon for the underwriter by Brownstein Hyatt Farber Schreck, P.C., Denver, Colorado.

#### EXPERTS

The financial statements of VirnetX, Inc. as of December 31, 2006 and 2005 and for the periods then ended included in the prospectus have been audited by the independent registered public accounting firm of Burr, Pilger & Mayer LLP, to the extent and for the periods ended December 31, 2006 and 2005, and are included in reliance upon such report given upon the authority of Burr, Pilger & Mayer LLP as experts in auditing and accounting. The consolidated financial statements of VirnetX Holding Corporation as of and for the periods therein indicated included in the prospectus have been audited by the independent registered public accounting firm of Farber Hass Hurley & McEwen, LLP, to the extent and for the periods set forth in their report appearing in this prospectus, and are included in reliance upon such report given upon the authority of Farber Hass Hurley & McEwen, LLP as experts in auditing and accounting.

#### WHERE YOU CAN FIND MORE INFORMATION

We have filed a registration statement on Form SB-2 with the SEC of which this prospectus is a part under the Securities Act with respect to the shares of common stock offered by this prospectus. This prospectus does not contain all of the information included in the registration statement, and statements contained in this prospectus concerning the provisions of any document are not necessarily complete. For further information about us and the shares of common stock covered by this prospectus, you should read the registration statement including its exhibits.

We file annual reports on Form 10-KSB, quarterly reports of Form 10-QSB, current reports on Form 8-K, proxy statements and other information with the SEC under the Exchange Act. You may read and copy this information at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, D.C. 20549. Please call the SEC at (800) 732-0330 for further information on the operation of the SEC's Public Reference Room. The SEC also maintains an internet site that contains reports, proxy statements and other information about issuers, like us, who file electronically with the SEC. The address of the SEC's web site is [www.sec.gov](http://www.sec.gov).

We intend to furnish our holders of common stock with annual reports containing financial statements audited by an independent accounting firm and to make available quarterly reports containing unaudited financial information for the first three quarters of each year.

## PROVISION FOR INDEMNIFICATION

### Commission Position on Indemnification

Insofar as indemnification for liabilities arising under the Securities Act may be permitted to our directors, officers and their respective controlling persons, or otherwise, we have been advised that in the opinion of the SEC such indemnification is against public policy as expressed in the Securities Act and is, therefore, unenforceable.

### Delaware General Corporation Law

Section 145 of the Delaware General Corporation Law provides that a corporation may indemnify directors and officers as well as other employees and individuals against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by such person in connection with any threatened, pending or completed actions, suits or proceedings in which such person is made a party by reason of such person being or having been a director, officer, employee or agent to the company. The Delaware General Corporation Law provides that Section 145 is not exclusive of other rights to which those seeking indemnification may be entitled under any bylaw, agreement, vote of stockholders or disinterested directors or otherwise.

Section 102(b)(7) of the Delaware General Corporation Law permits a corporation to provide in its certificate of incorporation that a director of the corporation shall not be personally liable to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, except for liability for any breach of the director's duty of loyalty to the corporation or its stockholders, for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, for unlawful payments of dividends or unlawful stock repurchases, redemptions or other distributions or for any transaction from which the director derived an improper personal benefit.

### Certificate of Incorporation

Our Certificate of Incorporation provides that the personal liability of the directors of the Company shall be eliminated to the fullest extent permitted by the provisions of Section 102(b)(7) of the Delaware General Corporation Law, as the same may be amended and supplemented.

Our Certificate of Incorporation provides that the Company shall, to the fullest extent permitted by the provisions of Section 145 of the Delaware General Corporation Law, as the same may be amended and supplemented, indemnify any and all persons whom it shall have power to indemnify under said section from and against any and all of the expenses, liabilities or other matters referred to in or covered by said section, and the indemnification provided for therein shall not be deemed exclusive of any other rights to which those indemnified may be entitled under any bylaw, agreement, vote of stockholders or disinterested directors or otherwise, both as to action in his official capacity and as to action in another capacity while holding such office, and shall continue as to a person who has ceased to be a director, officer, employee or agent and shall inure to the benefit of the heirs, executors and administrators of such a person.

### Indemnification Agreements

We have also entered into indemnification agreements with our directors and officers. The indemnification agreements provide indemnification to our directors and officers under certain circumstances for acts or omissions which may not be covered by directors' and officers' liability insurance.

### Liability Insurance

We have also obtained directors' and officers' liability insurance, which insures against liabilities that our directors or officers may incur in such capacities.

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**REPORT OF INDEPENDENT ACCOUNTANTS**

To the Board of Directors and Stockholders of  
VirnetX, Inc.

We have audited the accompanying balance sheets of VirnetX, Inc., (a development stage enterprise) as of December 31, 2006 and 2005, and the related statements of operations, stockholders' equity (deficit), and cash flows for the year ended December 31, 2006 and the period from August 2, 2005 (date of inception) to December 31, 2005, and cumulatively for the period from August 2, 2005 (date of inception) to December 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amount 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 financial position of VirnetX, Inc., as of December 31, 2006 and 2005, and the results of its operations and cash flows for the year ended December 31, 2006 and for the period from August 2, 2005 (date of inception) to December 31, 2005 and for the cumulative period from August 2, 2005 (date of inception) to December 31, 2006, in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As shown in the financial statements, the Company has incurred net losses since its inception and operating cash flow deficiencies, which raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to those matters also are described in Note 2. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ Burr, Pilger & Mayer, LLP

Palo Alto, CA  
April 30, 2007

**VirnetX, Inc.**  
**(a development stage enterprise)**

**BALANCE SHEETS**

	<u>As of December 31, 2006</u>	<u>As of December 31, 2005</u>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 139,997	\$ 86,552
Prepaid expenses and other current assets	26,945	61,170
Total current assets	166,942	147,722
Property and equipment, net	27,087	—
Other assets	1,094	—
Total assets	\$ 195,123	\$ 147,722
<b>LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)</b>		
Current liabilities:		
Accounts payable	\$ 87,386	\$ —
Advance from preferred stockholders	—	230,000
Total current liabilities	87,386	230,000
Commitments and contingencies:		
Stockholders' equity (deficit):		
Preferred stock, par value \$0.0003 per share:		
Authorized: 4,095,238 shares		
Issued and outstanding: 468,000 and no shares at December 31, 2006 and 2005, respectively		
Liquidation preference: \$1,404,000	1,377,625	—
Common stock, par value \$0.0003 per share:		
Authorized: 20,000,000 shares		
Issued and outstanding: 1,411,667 and 1,333,333 shares at December 31, 2006 and 2005, respectively		
Additional paid-in capital	424	400
	1,013,655	799,800
Due from stockholder	(150)	—
Deficit accumulated during the development stage	(2,283,817)	(882,478)
Total stockholders' equity (deficit)	107,737	(82,278)
Total liabilities and stockholders' equity (deficit)	\$ 195,123	\$ 147,722

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

**VirnetX, Inc.**  
**(a development stage enterprise)**

**STATEMENTS OF OPERATIONS**

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	Year Ended December 31, 2006	Period from August 2, 2005 (Date of Inception) to December 31, 2005	Cumulative Period from August 2, 2005 (Date of Inception) to December 31, 2006
Operating expenses:			
Research and development	\$ 554,187	\$ 56,000	\$ 610,187
General and administrative	853,488	826,478	1,679,966
Total operating expenses	<u>1,407,675</u>	<u>882,478</u>	<u>2,290,153</u>
Loss from operations	(1,407,675)	(882,478)	(2,290,153)
Interest and other income (expense), net	6,336	—	6,336
Net loss	<u>\$ (1,401,339)</u>	<u>\$ (882,478)</u>	<u>\$ (2,283,817)</u>

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

**VirnetX, Inc.**  
**(a development stage enterprise)**

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

	Series A Preferred Stock		Common Stock		Additional Paid-in Capital	Due from Stockholder	Deficit Accumulated During Development Stage	Total Stockholders' Equity (Deficit)
	Shares	Amount	Shares	Amount				
Balance at inception (August 2, 2005)	—	\$ —	—	\$ —	—	\$ —	\$ —	—
Common stock issued at \$0.0001875 per share to founders in August 2005	—	—	1,066,667	320	(120)	—	—	200
Proceeds from issuance of restricted stock units to employees at \$0.0003 per share in October 2005	—	—	266,666	80	—	—	—	80
Stock-based compensation from restricted stock units	—	—	—	—	799,920	—	—	799,920
Net loss	—	—	—	—	—	—	(882,478)	(882,478)
Balance at December 31, 2005	—	—	1,333,333	400	799,800	—	(882,478)	(82,278)
Proceeds from issuance of preferred stock at \$3.00 per share in February 2006, net of issuance cost of \$26,375	468,000	1,377,625	—	—	—	—	—	1,377,625
Proceeds from issuance of restricted stock units to employees at \$0.03 per share in March and October 2006	—	—	78,333	24	2,026	(150)	—	1,900
Stock-based compensation from restricted stock units	—	—	—	—	130,210	—	—	130,210
Stock-based compensation from employee stock options	—	—	—	—	81,619	—	—	81,619
Net loss	—	—	—	—	—	—	(1,401,339)	(1,401,339)
Balance at December 31, 2006	<u>468,000</u>	<u>\$ 1,377,625</u>	<u>1,411,667</u>	<u>\$ 424</u>	<u>\$ 1,013,655</u>	<u>\$ (150)</u>	<u>\$ (2,283,817)</u>	<u>\$ 107,737</u>

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



**VirnetX, Inc.**  
(a development stage enterprise)

**STATEMENTS OF CASH FLOWS**

	Year Ended December 31, 2006	Period from August 2, 2005 (Date of Inception) to December 31, 2005	Cumulative Period from August 2, 2005 (Date of Inception) to December 31, 2006
<b>Cash flows from operating activities:</b>			
Net loss	\$ (1,401,339)	\$ (882,478)	\$ (2,283,817)
<b>Adjustments to reconcile net loss to net cash used in operating activities:</b>			
Stock-based compensation	211,829	799,920	1,011,749
Depreciation and amortization	7,689	—	7,689
<b>Changes in operating assets and liabilities:</b>			
Prepaid expenses and other current assets	34,225	(61,170)	(26,945)
Other assets	(1,094)	—	(1,094)
Accounts payable	87,386	—	87,386
Net cash used in operating activities	<u>(1,061,304)</u>	<u>(143,728)</u>	<u>(1,205,032)</u>
<b>Cash flows from investing activities:</b>			
Purchase of property and equipment	(34,776)	—	(34,776)
Net cash used in investing activities	<u>(34,776)</u>	<u>—</u>	<u>(34,776)</u>
<b>Cash flows from financing activities:</b>			
Proceeds from issuance of preferred stock, net of issuance costs	1,147,625	—	1,147,625
Proceeds from issuance of restricted stock units	1,900	280	2,180
Proceeds from advance from preferred stockholders	—	230,000	230,000
Net cash provided by financing activities	<u>1,149,525</u>	<u>230,280</u>	<u>1,379,805</u>
Net increase in cash and cash equivalents	53,445	86,552	139,997
Cash and cash equivalents, beginning of period	86,552	—	—
Cash and cash equivalents, end of period	<u>\$ 139,997</u>	<u>\$ 86,552</u>	<u>\$ 139,997</u>
<b>Supplemental disclosure of cash flow information:</b>			
Cash paid during the year for taxes	<u>\$ 800</u>	<u>\$ —</u>	<u>\$ 800</u>
<b>Supplemental disclosure of noncash investing and financing activities:</b>			
Conversion of advance into preferred stock	<u>\$ 230,000</u>	<u>\$ —</u>	<u>\$ 230,000</u>

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

**VirnetX, Inc.**  
**(a development stage enterprise)**

**NOTES TO AUDITED FINANCIAL STATEMENTS**

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

VirnetX, Inc. ("VirnetX" or the "Company") was incorporated in the state of Delaware on August 2, 2005. VirnetX is a development stage company that is commercializing its patent portfolio to provide solutions for secure "real time" communications such as Instant Messaging (IM) and Voice over Internet Protocol (VoIP).

Most of the Company's issued and pending patents were acquired from SAIC, a systems, solutions and technical services company based in San Diego, California, in 2006. VirnetX has granted SAIC a limited license under these patents, but retains all right title and interest within the field of secure communications in the following areas: Virtual Private Networks; Secure Voice Over Internet Protocol; Electronic Mail (E-mail); Video Conferencing; Communications Logging; Dynamic Uniform Resource Locators; 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; Instant Messaging; Minimized Impact of Viruses; and Secure Session Initiation Protocol. The field of use is not limited by any predefined transport mode or medium of communication (e.g., wire, fiber, wireless, or mixed medium).

The Company is in the development stage and consequently, the Company is subject to the risks associated with development stage companies, including the need for additional financings; the uncertainty of the Company's intellectual property resulting in 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, the Company may 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.

The Company completed a 1 for 3 reverse stock split of its common stock and preferred stock which became effective on October 29, 2007. The financial statements have been adjusted retroactively to reflect this 1 for 3 reverse stock split of the common stock and preferred stock.

**2. Summary of Significant Accounting Policies**

*Basis of Presentation*

These financial statements are prepared on a going concern basis that contemplates the realization of assets and discharged liabilities in the normal course of business. The Company has incurred net operating losses and negative cash flows from operations. At December 31, 2006, the Company had an accumulated deficit of \$2,283,817. In order to continue its operations, the Company must achieve profitable operations or obtain additional financing. Management is currently pursuing financing alternatives, including private equity or debt financing, collaborative or other arrangements with corporate partners or other sources. There can be no assurance, however, that such a financing will be successfully completed on terms acceptable to the Company. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

*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.

**VirnetX, Inc.**  
**(a development stage enterprise)**

**NOTES TO AUDITED FINANCIAL STATEMENTS — (Continued)**

***Cash and Cash Equivalents***

The Company considers all highly liquid investments purchased with original maturities of three months or less 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 straight-line method over the estimated useful lives of the assets, which range from three to seven years. Repair and maintenance costs are charged to expense as incurred.

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

The Company's cash and cash equivalents are primarily maintained at one financial institution in the United States. Deposits held with these financial institutions may exceed the amount of insurance provided on such deposits. The balances are insured by the Federal Deposit Insurance Corporation up to \$100,000. At December 31, 2006, the Company's uninsured cash balances were \$46,153. The Company has not experienced any losses on its deposits of cash and cash equivalents.

***Comprehensive Income (Loss)***

The Company reports comprehensive income (loss) in accordance with the provisions of Statement of Financial Accounting Standards No. 130, Reporting Comprehensive Income, which establishes standards for reporting comprehensive income (loss) and its components in the financial statements. Comprehensive loss was equal to net loss for the years ended December 31, 2006 and 2005 and for the cumulative period from August 2, 2005 (date of inception) to December 31, 2006.

***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.

During 2006, 76% of research and development expenses were related to one outside design consultant.

***Income Taxes***

The Company accounts 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 bases 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 the Company's financial instruments, including cash and cash equivalents, accounts payable, and accrued liabilities, approximate their fair values due to their short maturities.

***Stock-Based Compensation***

The Company accounts for share-based compensation in accordance with Statement of Financial Accounting Standards (SFAS) 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

**VirnetX, Inc.**  
(a development stage enterprise)

**NOTES TO AUDITED FINANCIAL STATEMENTS — (Continued)**

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, the Company records 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 July 2006, the Financial Accounting Standards Board (FASB) issued Financial Interpretation No. 48, Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109 (“FIN 48”), which is a change in accounting for income taxes. FIN 48 specifies how tax benefits for uncertain tax positions are to be recognized, measured, and derecognized in financial statements; requires certain disclosures of uncertain tax matters; specifies how reserves for uncertain tax positions should be classified on the balance sheet; and provides transition and interim-period guidance, among other provisions. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact of FIN 48 on its financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company is currently assessing the potential impact that the adoption of SFAS No. 157 will have on its financial statements.

In February 2007, the FASB issued SFAS No. 159, “The Fair Value Option for Financial Assets and Liabilities” (“SFAS 159”). SFAS 159 provides entities with the option to report selected financial assets and liabilities at fair value. Business entities adopting SFAS 159 will report unrealized gains and losses in earnings at each subsequent reporting date on items for which fair value option has been elected. SFAS 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. SFAS 159 requires additional information that will help investors and other financial statement users to understand the effect of an entity’s choice to use fair value on its earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007, with earlier adoption permitted. The Company is currently assessing the impact that the adoption of SFAS 159 may have on our financial position, results of operations or cash flows.

**3. Property and Equipment, Net**

	Useful Life (In Years)	As of December 31, 2006	As of December 31, 2005
Furniture and fixtures	7	\$ 9,150	\$ —
Computers and equipment	5	25,626	—
		34,776	—
Less accumulated depreciation		(7,689)	—
		<u>\$ 27,087</u>	<u>\$ —</u>

**VirnetX, Inc.**  
**(a development stage enterprise)**

**NOTES TO AUDITED FINANCIAL STATEMENTS — (Continued)**

The Company's fixed assets are all located in the United States. Depreciation and amortization expense was \$7,689 and \$0 for the year ended December 31, 2006 and for the period August 2, 2005 to December 31, 2005, respectively. Depreciation and amortization expense was \$7,689 for the period from August 2, 2005 (date of inception) to December 31, 2006.

**4. Commitments**

***Operating Lease Agreements***

The Company leases its office space under a noncancelable operating lease that expires in April 2007. The Company recognizes rent expenses on a straight-line basis over the lease period.

Future minimum facility lease payments at December 31, 2006 are as follows:

2007 \$ 3,731

Rent expense for the years ended December 31, 2006 and for the period August 2, 2005 to December 31, 2005 was \$8,209 and \$0, respectively. Rent expense for the period from August 2, 2005 (date of inception) to December 31, 2006 was \$8,209.

***Patent Assignment Agreement with SAIC***

The Company's patents are based on patents and patent applications originally acquired from SAIC. VirnetX acquired these patents and patent applications from SAIC pursuant to the Assignment Agreement by and between VirnetX and SAIC dated December 21, 2006, and the Patent License and Assignment Agreement by and between VirnetX and SAIC dated August 12, 2005, as amended on November 2, 2006. Under the terms of these agreements, the Company will pay SAIC a minimum guaranteed royalty of \$50,000 annually beginning in July, 2008. In addition, the Company will pay to SAIC royalties in the amount of 15% of gross revenues up to a maximum amount of \$35 million less any amounts already paid by the Company to SAIC. At March 31, 2007 no payments have been made to SAIC under the terms of these agreements.

Our business depends on our rights to and under the patents, including the patents and patent applications which were assigned to us by SAIC. Our agreements with SAIC impose obligations on us, such as payment obligations. If SAIC believes that we have failed to meet these obligations, SAIC could seek to limit or reacquire the assigned patents and patent applications, 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. If our rights in our patents were restricted or ultimately lost, our ability to continue our business based on the affected technology platform could be severely adversely affected.

The Company granted SAIC a security interest in some of our intellectual property, including our patents, to secure our payment obligations to SAIC described above.

**5. Preferred Stock**

Preferred stock at December 31, 2006 consists of the following:

<u>Series</u>	<u>Date Issued</u>	<u>Original Issue Price</u>	<u>Shares Authorized</u>	<u>Shares Outstanding</u>
Series A Preferred	March 27, 2006	\$ 3.00	666,667	468,000

**VirnetX, Inc.**  
**(a development stage enterprise)**

**NOTES TO AUDITED FINANCIAL STATEMENTS — (Continued)**

***Voting***

Each share of convertible preferred stock has voting rights equal to an equivalent number of shares of common stock into which it is convertible and votes together as one class with the common stock.

***Dividends***

Holders of convertible preferred stock are entitled to receive dividends prior to and in preference to any declaration or payment of any dividends on the common stock, at the rate of \$0.24 per share per annum on each outstanding share of Series A preferred stock, payable quarterly. Such dividends shall be payable only when, as, and if declared by the Board of Directors and shall not be cumulative. After payment of such dividends, any additional dividends shall be distributed among the Series A preferred stock and common stock pro rata based on the number of shares of common stock then held by each holder (assuming conversion of all such Series A preferred stock into common stock).

***Liquidation***

In the event of any liquidation, dissolution or winding up of the Company, either voluntary or involuntary, the holders of Series A preferred stock is entitled to receive, prior and in preference to any distribution of any assets of the Corporation to the holders of common stock, an amount per share equal to \$3.00 per share for each share of Series A preferred stock then held by them, plus any declared but unpaid dividends. The remaining assets, if any, shall be distributed among the holders of common stock and convertible preferred stock, pro rata based on the number of shares of common stock held by each holder assuming the conversion of all such redeemable convertible preferred stock. If the Company's legally available assets are insufficient to satisfy the liquidation preferences, the funds will be distributed ratably among the holders of Series A preferred stock, in proportion to the amounts each holder would receive if the Company had sufficient assets and funds to pay the full preferential amount.

***Conversion***

Each share of convertible preferred stock is convertible, at the option of the holder, into a number of fully paid and nonassessable shares of common stock as is determined by dividing \$3.00 by the conversion price applicable to such share, determined as hereafter provided, in effect on the due date the certificate is surrendered for conversion. The initial conversion price per share of Series A Preferred Stock shall be \$3.00 and is subject to adjustments in accordance with antidilution provisions, including stock splits and stock dividends, contained in the Company's Certificate of Incorporation.

Each share of Series A preferred stock automatically converts into shares of common stock at the conversion price at the time in effect for such share immediately upon the earlier of (1) the Company's sale of its common stock in a firm commitment underwritten public offering which results in aggregate cash proceeds to the Company of not less than \$8,000,000, (2) any reverse merger that yields working capital to the Company of at least \$8,000,000 and which results in the Company's shares being registered under Securities Exchange Act of 1934, (3) the date specified by the written consent or agreement of the holders of a majority of the then outstanding shares of Series A preferred stock.

At December 31, 2006, the Company has reserved sufficient shares of common stock for issuance upon conversion of the convertible preferred stock.

***Redemption***

The Series A preferred stock is not mandatorily redeemable.

**VirnetX, Inc.**  
**(a development stage enterprise)**

**NOTES TO AUDITED FINANCIAL STATEMENTS — (Continued)**

In February 2006, the Company issued 468,000 shares of Series A preferred stock at \$3.00 per share and received net proceeds of \$1,377,625. A portion of the proceeds were advanced by the preferred shareholders in 2005 totaling \$230,000.

**6. Common Stock**

Each share of common stock has the right to one vote. The holders of common stock are also 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 by the Board from inception through December 31, 2006. The Company's restated Certificate of Incorporation, as amended in March 2006, authorizes the Company to issue 20,000,000 shares of \$0.0003 par value common stock.

In August 2005, the Company issued 1,066,667 shares of common stock to founders at \$0.0001875 per share for aggregate proceeds of \$200.

The Company has also issued Restricted Stock Units ("RSUs") to employees and consultants as discussed in Note 7.

**7. Stock Plan**

In 2005, the Company adopted the 2005 Stock Plan (the "Plan"). The Plan provides for the granting of stock options and restricted stock units to employees and consultants of the Company. Stock options granted under the Plan may be either incentive stock options or nonqualified stock options. Incentive stock options ("ISO") may be granted only to Company employees (including officers and directors who are also employees). Nonqualified stock options ("NSO") may be granted to Company employees and consultants. The Company has reserved 933,333 shares of common stock for issuance under the Plan. The Company received proceeds of \$80 and \$24 from the issuance of 266,667 and 78,333 shares of restricted stock units during the years ended December 31, 2006 and 2005, respectively.

Options under the Plan may be granted for periods of up to ten years and at prices no less than 85% of the estimated fair 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% and 85% of the estimated fair value of the shares on the date of grant, respectively, and the exercise price of an ISO and NSO granted to a 10% stockholder shall not be less than 110% of the estimated fair value of the shares on the date of grant.

**VirnetX, Inc.**  
(a development stage enterprise)

**NOTES TO AUDITED FINANCIAL STATEMENTS — (Continued)**

Activity under the Plan is as follows:

	Shares Available for Grant	Options Outstanding	
		Number of Shares	Weighted Average Exercise Price
Shares reserved for the Plan at inception	933,333	—	—
Restricted stock units granted	(266,666)	—	—
Options granted	—	—	—
Options exercised	—	—	—
Options cancelled	—	—	—
<b>Balance at December 31, 2005</b>	<b>666,667</b>	<b>—</b>	<b>—</b>
Restricted stock units granted	(85,000)	—	—
Options granted	(150,000)	150,000	\$ 3.00
Options exercised	—	—	—
Options cancelled	—	—	—
<b>Balance at December 31, 2006</b>	<b>431,667</b>	<b>150,000</b>	<b>\$ 3.00</b>

The Company had during the year ended December 31, 2006 restricted stock units granted for 6,667 shares that had been approved by the Board of Directors, but not signed by the restricted stock holders. Accordingly, these shares have been reflected to reduce shares available for grant. The unamortized stock-based compensation expense related to restricted stock units at December 31, 2006 was \$102,739, which will be amortized over approximately the next three years.

**8. Stock-Based Compensation**

The Company accounts for equity instruments issued to employees in accordance with the provisions of SFAS 123R which requires that such equity instruments are recorded at their fair value on the grant date. The future expensing of stock-based compensation is subject to periodic adjustments as the underlying equity instruments vest.

At December 31, 2006 and December 31, 2005, the fair value of common stock was \$3.00 per share. The Company has recorded \$211,829 and \$799,920 in employee stock-based compensation expense for the year ended December 31, 2006 and the five month period ending December 31, 2005, respectively.

The Company elected to adopt the modified retrospective application method as provided by SFAS No. 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 the date of inception. The effect of recording stock-based compensation for year ended December 31, 2006 and the five month period ended December 31, 2005 was as follows:

Stock-Based Compensation by Type of Award	Year Ended	Five Months Ended
	December 31, 2006	December 31, 2005
Restricted stock units	\$ 130,210	\$ 799,920
Employee stock options	81,619	—
<b>Total stock-based compensation</b>	<b>\$ 211,829</b>	<b>\$ 799,920</b>



**VirnetX, Inc.**  
**(a development stage enterprise)**

**NOTES TO AUDITED FINANCIAL STATEMENTS — (Continued)**

As of December 31, 2006, the unrecorded deferred stock-based compensation balance related to stock options was \$282,986 and will be recognized over an estimate weighted average amortization period of approximately 3.4 years.

The fair value of each option grant during the year ended December 31, 2006 was estimated on the date of grant using the following assumptions.

Volatility	100%
Risk-free interest rate	4.77%
Expected life	6 years
Expected dividends	0%

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. The Company has not provided an estimate for forfeitures because the Company has no history of forfeited options and believes that all outstanding options at December 31, 2006 will vest. In the future, the Company may change this estimate based on actual and expected future forfeiture rates. Based on the Black-Scholes option pricing model, the weighted average estimated fair value of employee stock option grants was \$2.43 for the year ended December 31, 2006.

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

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Outstanding at December 31, 2005	—	\$ —	—	\$ —
Options granted	150,000	3.00	9.4	—
Options exercised	—	—	—	—
Options cancelled	—	—	—	—
Outstanding at December 31, 2006	150,000	\$ 3.00	9.4	\$ —

The following table summarizes information about stock options at December 31, 2006:

	Options Outstanding			Options Vested and Exercisable		
	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)
Range of Exercise Price						
\$ 3.00	150,000	9.4	\$ 3.00	13,333	\$ 3.00	9.2

**9. Income Taxes**

As of December 31, 2006, the Company had approximately \$1,236,000 of federal and \$1,219,000 of state net operating loss carryforwards available to offset future taxable income. Federal and state net operating losses expire in varying amounts beginning in 2025 and 2015, respectively. Under the Tax Reform Act of 1986, the amounts of and benefits from net operating loss carryforwards may be impaired or limited in certain circumstances. Events which cause limitations in the amount of net operating losses that the Company may utilize in any one year include, but are not limited to, a cumulative ownership change of more than 50%, as defined, over a three year period.

**VirnetX, Inc.**  
**(a development stage enterprise)**

**NOTES TO AUDITED FINANCIAL STATEMENTS — (Continued)**

As of December 31, 2006, the Company had credit carryforwards of approximately \$95,000 and \$112,000 available to reduce future taxable income, if any, for both federal and state income tax purposes, respectively. The federal credit carryforwards expire beginning 2025, the state credits have no expiration date.

Temporary differences and carryforwards which gave rise to significant portions of deferred tax assets are as follows:

<u>Deferred Tax Asset</u>	<u>As of December 31, 2006</u>	<u>As of December 31, 2005</u>
Tax benefit of net operating loss carryforwards	\$ 542,000	\$ 36,000
Research tax credit	207,000	—
Subtotal	749,000	36,000
Less valuation allowance	(749,000)	(36,000)
Total	<u>\$ —</u>	<u>\$ —</u>

Management believes that, based on a number of factors, it is more likely than not that the deferred tax assets will not be utilized, such that a full valuation allowance has been recorded. The valuation allowance increased by \$713,000 for the year ended December 31, 2006.

**10. Subsequent Events**

In January 2007, the Company's preferred stock shareholders voted to convert their shares of preferred stock to common stock upon the planned reverse merger.

In January 2007, the Company announced that it had entered into a non-binding term sheet to merge with VirnetX Holding Corporation (formerly, PASW, Inc.).

In February 2007, the Company received a loan of \$500,000 from several of its Series A shareholders. The notes have an annual interest rate of 6% and will be converted into the Company's common stock upon the close of the Merger. These preferred shareholders agreed to convert their Series A preferred shares to shares of the Company's common stock upon the close of the Merger.

**VirnetX, Inc.**  
**(a development stage enterprise)**

**BALANCE SHEETS**

	As of June 30, 2007 (Unaudited)	As of December 31, 2006
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 86,835	\$ 139,997
Prepaid expenses and other current assets	488,165	26,945
Total current assets	575,000	166,942
Property and equipment, net	28,742	27,087
Other assets	1,244	1,094
Total assets	<u>\$ 604,986</u>	<u>\$ 195,123</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)</b>		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 897,297	\$ 87,386
Note payable	50,000	—
Convertible notes payable, related party	215,869	—
Convertible notes payable	1,284,131	—
Total current liabilities	<u>2,447,297</u>	<u>87,386</u>
Commitments and contingencies:		
Stockholders' equity (deficit):		
Preferred stock, par value \$0.0003 per share:		
Authorized: 4,095,238 shares		
Issued and outstanding: 468,000 and 468,000 shares at June 30, 2007 and December 31, 2006, respectively		
Liquidation preference: \$1,404,000	1,377,625	1,377,625
Common stock, par value \$0.0003 per share:		
Authorized: 20,000,000 shares		
Issued and outstanding: 1,418,333 and 1,411,667 shares at June 30, 2007 and December 31, 2006, respectively		
Additional paid-in capital	1,075,368	1,013,655
Due from stockholder	—	(150)
Deficit accumulated during the development stage	(4,295,730)	(2,283,817)
Total stockholders' equity (deficit)	<u>(1,842,311)</u>	<u>107,737</u>
Total liabilities and stockholders' equity (deficit)	<u>\$ 604,986</u>	<u>\$ 195,123</u>

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

**VirnetX, Inc.**  
**(a development stage enterprise)**  
**STATEMENTS OF OPERATIONS**

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	<u>Six Months Ended</u> <u>June 30, 2007</u> <u>(Unaudited)</u>	<u>Six Months Ended</u> <u>June 30, 2006</u> <u>(Unaudited)</u>	<u>Cumulative Period</u> <u>from</u> <u>August 2, 2005</u> <u>(Date of Inception)</u> <u>to</u> <u>June 30, 2007</u> <u>(Unaudited)</u>
Operating expenses:			
Research and development	\$ 268,178	\$ 317,763	\$ 878,365
General and administrative	1,698,247	399,622	3,378,213
Total operating expenses	<u>1,966,425</u>	<u>717,385</u>	<u>4,256,578</u>
Loss from operations	(1,966,425)	(717,385)	(4,256,578)
Interest and other income (expense), net	(45,488)	(5,564)	(39,152)
Net loss	<u>\$ (2,011,913)</u>	<u>\$ (722,949)</u>	<u>\$ (4,295,730)</u>

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

**VirnetX, Inc.**  
**(a development stage enterprise)**  
**STATEMENTS OF CASH FLOWS**

	Six Months Ended June 30, 2007 (Unaudited)	Six Months Ended June 30, 2006 (Unaudited)	Cumulative Period from August 2, 2005 (Date of Inception) to June 30, 2007 (Unaudited)
<b>Cash flows from operating activities:</b>			
Net loss	\$ (2,011,913)	\$ (722,949)	\$ (4,295,730)
<b>Adjustments to reconcile net loss to net cash used in operating activities:</b>			
Stock-based compensation	41,715	171,673	1,053,464
Depreciation and amortization	7,300	1,590	14,989
<b>Changes in operating assets and liabilities:</b>			
Prepaid expenses and other current assets	(461,220)	59,713	(488,165)
Other assets	(150)	(1,244)	(1,244)
Accounts payable	809,911	6,296	897,297
Net cash used in operating activities	<u>(1,614,357)</u>	<u>(484,921)</u>	<u>(2,819,389)</u>
<b>Cash flows from investing activities:</b>			
Purchase of property and equipment	(8,955)	(32,731)	(43,731)
Net cash used in investing activities	<u>(8,955)</u>	<u>(32,731)</u>	<u>(43,731)</u>
<b>Cash flows from financing activities:</b>			
Proceeds for short term note payable	50,000	—	50,000
Proceeds from issuance of preferred stock, net of issuance costs	—	1,147,625	1,147,625
Proceeds from issuance of common stock	20,150	—	22,330
Proceeds from advance from preferred stockholders	—	—	230,000
Proceeds from convertible notes issuances	1,500,000	—	1,500,000
Net cash provided by financing activities	<u>1,570,150</u>	<u>1,147,625</u>	<u>2,949,955</u>
Net increase in cash and cash equivalents	<u>(53,162)</u>	<u>629,973</u>	<u>86,835</u>
Cash and cash equivalents, beginning of period	139,997	86,552	—
Cash and cash equivalents, end of period	<u>\$ 86,835</u>	<u>\$ 716,525</u>	<u>\$ 86,835</u>

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

**VirnetX, Inc.**  
**(a development stage enterprise)**

**NOTES TO UNAUDITED FINANCIAL STATEMENTS**

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

VirnetX, Inc. ("VirnetX" or the "Company") was incorporated in the state of Delaware on August 2, 2005. VirnetX is a development stage company that is commercializing its patent portfolio to provide solutions for secure "real time" communications such as Instant Messaging (IM) and Voice over Internet Protocol (VoIP).

Most of the Company's issued and pending patents were acquired from SAIC, a systems, solutions and technical services company based in San Diego, California, in 2006. VirnetX has granted SAIC a limited license under these patents, but retains all right title and interest within the field of secure communications in the following areas: Virtual Private Networks; Secure Voice Over Internet Protocol; Electronic Mail (E-mail); Video Conferencing; Communications Logging; Dynamic Uniform Resource Locators; 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; Instant Messaging; Minimized Impact of Viruses; and Secure Session Initiation Protocol. The field of use is not limited by any predefined transport mode or medium of communication (e.g., wire, fiber, wireless, or mixed medium).

The Company is in the development stage and consequently, the Company is subject to the risks associated with development stage companies, including the need for additional financings; the uncertainty of the Company's intellectual property resulting in 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, the Company may 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.

These financial statements are prepared on a going concern basis that contemplates the realization of assets and discharged liabilities in the normal course of business. The Company has incurred net operating losses and negative cash flows from operations. At June 30, 2007, the Company had an accumulated deficit of \$4,295,730. In order to continue its operations, the Company must achieve profitable operations or obtain additional financing. Management is currently pursuing financing alternatives, including private equity or debt financing, collaborative or other arrangements with corporate partners or other sources. There can be no assurance, however, that such a financing will be successfully completed on terms acceptable to the Company. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

The Company completed a 1 for 3 reverse stock split of its common stock and preferred stock which became effective on October 29, 2007. The financial statements have been adjusted retroactively to reflect this 1 for 3 reverse stock split of the common stock and preferred stock.

**2. Summary of Significant Accounting Policies**

*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.

*Cash and Cash Equivalents*

The Company considers all highly liquid investments purchased with original maturities of three months or less to be cash equivalents.

**VirnetX, Inc.**  
**(a development stage enterprise)**

**NOTES TO UNAUDITED FINANCIAL STATEMENTS — (Continued)**

***Property and Equipment***

Property and equipment are stated at historical cost, less accumulated depreciation and amortization. Depreciation and amortization are computed using the straight line method 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***

The Company's 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 up to \$100,000. The Company had no uninsured cash balances as of June 30, 2007. During the six months ended June 30, 2007 the Company had, at times, funds that were uninsured. The Company has not experienced any losses on its deposits of cash and cash equivalents.

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

The Company identifies and records 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. 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.

***Comprehensive Income (Loss)***

The Company reports comprehensive income (loss) in accordance with the provisions of Statement of Financial Accounting Standards No. 130, Reporting Comprehensive Income, which establishes standards for reporting comprehensive income (loss) and its components in the financial statements. Comprehensive loss was equal to net loss for the periods ended June 30, 2007 and 2006 and for the cumulative period from August 2, 2005 (date of inception) to June 30, 2007.

***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***

The Company accounts 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 the Company's financial instruments, including cash and cash equivalents, accounts payable, notes payable, accrued liabilities and approximate their fair values due to their short maturities.

**VirnetX, Inc.**  
(a development stage enterprise)

**NOTES TO UNAUDITED FINANCIAL STATEMENTS — (Continued)**

**Stock-Based Compensation**

The Company accounts for share-based compensation 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 123R had been applied from the date of inception.

**Recent Accounting Pronouncements**

In September 2006, the FASB issued SFAS No. 157 “Fair Value Measurements” (“SFAS 157”), which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective in fiscal years beginning after November 15, 2007.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, “The Fair Value Option for Financial Assets and Liabilities” (“SFAS 159”). SFAS 159 provides entities with the option to report selected financial assets and liabilities at fair value. Business entities adopting SFAS 159 will report unrealized gains and losses in earnings at each subsequent reporting date on items for which fair value option has been elected. SFAS 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. SFAS 159 requires additional information that will help investors and other financial statement users to understand the effect of an entity’s choice to use fair value on its earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007, with earlier adoption permitted. The Company is currently assessing the impact that the adoption of SFAS 159 may have on our financial position, results of operations or cash flows.

**3. Property and Equipment, net**

	Useful Life (In Years)	As of June 30, 2007	As of December 31, 2006
Furniture and fixtures	7	\$ 9,150	\$ 9,150
Computers and equipment	3 to 5	34,581	25,626
		43,731	34,776
Less accumulated depreciation		(14,989)	(7,689)
		<u>\$ 28,742</u>	<u>\$ 27,087</u>

Depreciation and amortization expense was \$7,300, \$1,590, and \$14,989 for the six months ended June 30, 2007 and June 30, 2006, and for the period from August 2, 2005 (date of inception) to June 30, 2007, respectively.

**4. Convertible Notes Payable**

During February 2007 the Company obtained bridge financing in the form of notes payable convertible into common stock upon the merger with VirnetX Holding Corporation (formerly, PASW, Inc.).

In February 2007, the Company received a loan of \$500,000 from several of its Series A preferred stock shareholders. The notes have an annual interest rate of 6% and will be paid in cash upon the close of the merger. These preferred shareholders agreed to convert their Series A preferred shares to shares of the Company’s common stock upon the close of the merger.



**VirnetX, Inc.**  
**(a development stage enterprise)**

**NOTES TO UNAUDITED FINANCIAL STATEMENTS — (Continued)**

In February 2007, the Company received another loan from a new investor for \$1,000,000. This note has an annual interest rate of 10% payable monthly. Of the \$1,000,000 proceeds, the Company was obligated to use \$350,000 to be deposited as a retainer for legal counsel. This \$350,000 is classified in prepaid expenses and other current assets on the Company's June 30, 2007 balance sheet. This investor has committed to purchasing an additional \$3,000,000 of the Company's common stock upon consummation of the merger with VirnetX Holding Corporation. This \$3,000,000 has been placed into escrow and will be remitted to the Company upon the close of the merger.

On June 28, 2007, the Company borrowed \$50,000 on a short-term note from the same investor who loaned the Company the \$1,000,000 mentioned above. This note has an annual interest rate of 10% payable monthly. This loan plus accrued interest was repaid on July 10, 2007.

**5. Commitments**

*Operating Lease Agreements*

The Company leases its office space under a noncancelable operating lease that expires in April 2008. The Company recognizes rent expenses on a straight-line basis over the lease period.

Future minimum facility lease payments at June 30, 2007 are as follows:

2007	\$ 7,462
2008	\$ 3,731

Rent expense was \$7,463, \$2,289, and \$15,672 for the six months ended June 30, 2007 and June 30, 2006, and for the period from August 2, 2005 (date of inception) to June 30, 2007, respectively.

*Patent Assignment Agreement with SAIC*

The Company's patents are based on patents and patent applications originally acquired from SAIC. VirnetX acquired these patents and patent applications from SAIC pursuant to the Assignment Agreement by and between VirnetX and SAIC, dated December 21, 2006, and the patent License and Assignment Agreement by and between VirnetX and SAIC dated August 12, 2005, as amended on November 2, 2006. Under the terms of these agreements, the Company will pay SAIC a minimum guaranteed royalty of \$50,000 annually beginning in July, 2008. In addition, the Company will pay to SAIC royalties in the amount of 15% of gross revenues up to a maximum amount of \$35 million less any amounts already paid by the Company to SAIC. At March 31, 2007 no payments have been made to SAIC under the terms of these agreements.

Our business depends on the Company's rights to and under the patents, including the patents and patent applications which were assigned to the Company by SAIC. The Company's agreements with SAIC impose obligations on us, such as payment obligations. If SAIC believes that the Company has failed to meet these obligations, SAIC could seek to limit or reacquire the assigned patents and patent applications, which could lead to costly and time-consuming litigation and, potentially, a loss of the Company's rights in patents. During the period of any such litigation, the Company's ability to carry out the development and commercialization of potential products could be significantly and negatively affected. If the Company's rights in these patents were restricted or ultimately lost, their ability to continue the business based on the affected technology platform could be severely, adversely affected.

The Company granted SAIC a security interest in some of the Company's intellectual property, including patents, to secure their payment obligations to SAIC described above.

See NOTE 11 for a description of pending litigation.

**VirnetX, Inc.**  
**(a development stage enterprise)**

**NOTES TO UNAUDITED FINANCIAL STATEMENTS — (Continued)**

**6. Preferred Stock**

Preferred stock at June 30, 2007 and December 31, 2006 consist of the following:

<u>Series</u>	<u>Date Issued</u>	<u>Original Issue Price</u>	<u>Shares Authorized</u>	<u>Shares Outstanding</u>
Series A Preferred	March 27, 2006	\$ 3.00	666,667	468,000

***Voting***

Each share of convertible preferred stock has voting rights equal to an equivalent number of shares of common stock into which it is convertible and votes together as one class with the common stock.

***Dividends***

Holders of convertible preferred stock are entitled to receive dividends prior to and in preference to any declaration or payment of any dividends on the common stock, at the rate of \$0.24 per share per annum on each outstanding share of Series A preferred stock, payable quarterly. Such dividends shall be payable only when, as, and if declared by the Board of Directors and shall not be cumulative. After payment of such dividends, any additional dividends shall be distributed among the Series A preferred stock and common stock pro rata based on the number of shares of common stock then held by each holder (assuming conversion of all such Series A preferred stock into common stock).

***Liquidation***

In the event of any liquidation, dissolution or winding up of the Company, either voluntary or involuntary, the holders of Series A preferred stock is entitled to receive, prior and in preference to any distribution of any assets of the Corporation to the holders of common stock, an amount per share equal to \$3.00 per share for each share of Series A preferred stock then held by them, plus any declared but unpaid dividends. The remaining assets, if any, shall be distributed among the holders of common stock and convertible preferred stock, pro rata based on the number of shares of common stock held by each holder assuming the conversion of all such redeemable convertible preferred stock. If the Company's legally available assets are insufficient to satisfy the liquidation preferences, the funds will be distributed ratably among the holders of Series A preferred stock, in proportion to the amounts each holder would receive if the Company had sufficient assets and funds to pay the full preferential amount.

***Conversion***

Each share of convertible preferred stock is convertible, at the option of the holder, into a number of fully paid and nonassessable shares of common stock as is determined by dividing \$3.00 by the conversion price applicable to such share, determined as hereafter provided, in effect on the due date the certificate is surrendered for conversion. The initial conversion price per share of Series A Preferred Stock shall be \$3.00 and is subject to adjustments in accordance with antidilution provisions, including stock splits and stock dividends, contained in the Company's Certificate of Incorporation.

Each share of Series A preferred stock automatically converts into shares of common stock at the conversion price at the time in effect for such share immediately upon the earlier of (1) the Company's sale of its common stock in a firm commitment underwritten public offering which results in aggregate cash proceeds to the Company of not less than \$8,000,000, (2) any reverse merger that yields working capital to the Company of at least \$8,000,000 and which results in the Company's shares being registered under Securities Exchange Act of 1934, (3) the date specified by the written consent or agreement of the holders of a majority of the then outstanding shares of Series A preferred stock.

**VirnetX, Inc.**  
**(a development stage enterprise)**

**NOTES TO UNAUDITED FINANCIAL STATEMENTS — (Continued)**

At June 30, 2007, the Company has reserved sufficient shares of common stock for issuance upon conversion of the convertible preferred stock.

**Redemption**

The Series A preferred stock is not mandatorily redeemable.

In February 2006, the Company issued 468,000 shares of Series A preferred stock at \$3.00 per share and received net proceeds of \$1,377,625. A portion of the proceeds were advanced by the preferred shareholders in 2005 totaling \$230,000.

**7. Common Stock**

Each share of common stock has the right to one vote. The holders of common stock are also 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 by the Board from inception through December 31, 2006. The Company's restated Certificate of Incorporation, as amended in March 2006, authorizes the Company to issue 20,000,000 shares of \$0.0003 par value common stock.

In August 2005, the Company issued 1,066,667 shares of common stock to founders at \$0.0001875 per share for aggregate proceeds of \$200.

The Company has also issued Restricted Stock Units ("RSUs") to employees and consultants as discussed in Note 8.

**8. Stock Plan**

In 2005, the Company adopted the 2005 Stock Plan (the "Plan"). The Plan provides for the granting of stock options and restricted stock units to employees and consultants of the Company. Stock options granted under the Plan may be either incentive stock options or nonqualified stock options. Incentive stock options ("ISO") may be granted only to Company employees (including officers and directors who are also employees). Nonqualified stock options ("NSO") may be granted to Company employees and consultants. The Company has reserved 933,333 shares of common stock for issuance under the Plan. The Company received proceeds of \$80 and \$24 from the issuance of 266,667 and 78,333 shares of restricted stock units during the years ended December 31, 2006 and 2005, respectively.

Options under the Plan may be granted for periods of up to ten years and at prices no less than 85% of the estimated fair 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% and 85% of the estimated fair value of the shares on the date of grant, respectively, and the exercise price of an ISO and NSO granted to a 10% stockholder shall not be less than 110% of the estimated fair value of the shares on the date of grant.

The Company had during the year ended December 31, 2006 restricted stock units granted for 6,667 shares that had been approved by the Board of Directors, but not signed by the restricted stock holders. Accordingly, these shares have been reflected to reduce shares available for grant. The unamortized stock based compensation expense related to restricted stock units at June 30, 2007 was \$102,739, which will be recognized over approximately the next three years.

During May 2007, options were exercised to purchase 6,667 shares of common stock for proceeds to the Company of \$20,000.

**VirnetX, Inc.**  
(a development stage enterprise)

**NOTES TO UNAUDITED FINANCIAL STATEMENTS — (Continued)**

Activity under the Plan is as follows:

	Shares Available for Grant	Options Outstanding	
		Number of Shares	Weighted Average Exercise Price
Shares reserved for the Plan at inception	933,333	—	—
Restricted stock units granted	(266,666)	—	—
Options granted	—	—	—
Options exercised	—	—	—
Options cancelled	—	—	—
<b>Balance at December 31, 2005</b>	<b>666,667</b>	<b>—</b>	<b>—</b>
Restricted stock units granted	(85,000)	—	—
Options granted	(150,000)	150,000	\$ 3.00
Options exercised	—	—	—
Options cancelled	—	—	—
<b>Balance at December 31, 2005</b>	<b>431,667</b>	<b>150,000</b>	<b>\$ 3.00</b>
Restricted stock units granted	—	—	—
Options granted	—	—	—
Options exercised	6,666	(6,667)	3.00
Options cancelled	—	—	—
<b>Balance at June 30, 2007</b>	<b>438,333</b>	<b>143,333</b>	<b>\$ 3.00</b>

**9. Stock-Based Compensation**

The Company accounts for equity instruments issued to employees in accordance with the provisions of SFAS 123R which requires that such equity instruments are recorded at their fair value on the grant date. The future expensing of stock-based compensation is subject to periodic adjustments as the underlying equity instruments vest.

At June 30, 2007 and December 31, 2006, the fair value of common stock is \$3.00 per share. The Company has recorded \$41,715, \$171,673, and \$1,055,370 in employee stock-based compensation expense for the six months ended June 30, 2007 and June 30, 2006 and for the period from August 2, 2005 (date of inception) to June 30, 2007, respectively.

The Company elected to adopt the modified retrospective application method as provided by SFAS No. 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 the date of inception. The effect of recording stock-based compensation for the five month period ended December 31, 2005 and year ended December 31, 2006 was as follows:

Stock-Based Compensation by Type of Award	Six Months Ended June 30, 2007	Six Months Ended June 30, 2006	Cumulative Period
			from August 2, 2005 (Date of Inception) to June 30, 2007
Restricted stock units	\$ —	\$ 132,110	\$ 932,037
Employee stock options	41,715	39,563	123,333
<b>Total stock-based compensation</b>	<b>\$ 41,715</b>	<b>\$ 171,673</b>	<b>\$ 1,055,370</b>

**VirnetX, Inc.**  
**(a development stage enterprise)**

**NOTES TO UNAUDITED FINANCIAL STATEMENTS — (Continued)**

As the Company has provided for a full valuation allowance against deferred tax assets, there is no anticipated tax effect of stock-based compensation expense.

As of June 30, 2007, the unrecorded deferred stock-based compensation balance related to stock options was \$257,518, will be recognized over an estimate weighted average amortization period of approximately 2.8 years.

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

	Six Months Ended June 30, 2007	Six Months Ended June 30, 2006
Volatility	—	100%
Risk-free interest rate	—	4.77%
Expected life	—	6 years
Expected dividends	—	0%

No options have been granted from January 1, 2007 to June 30, 2007.

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. The Company has not provided an estimate for forfeitures because the Company has no history of forfeited options and believes that all outstanding options at June 30, 2007 will vest. In the future, the Company may change this estimate based on actual and expected future forfeiture rates. No options have been granted in 2007.

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

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Outstanding at December 31, 2005	—	\$ —	—	\$ —
Options granted	150,000	3.00	9.4	—
Options exercised	—	—	—	—
Options cancelled	—	—	—	—
Outstanding at December 31, 2006	150,000	3.00	9.4	—
Options granted	—	—	—	—
Options exercised	(6,667)	3.00	8.8	—
Options cancelled	—	—	—	—
Outstanding at June 30, 2007	143,333	\$ 3.00	9.1	\$ —

The following table summarizes information about stock options at June 30, 2007:

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 Exercise Price	Weighted Average Remaining Contractual Life (Years)
\$3.00	143,333	8.8	\$ 3.00	6,667	\$ 3.00	8.6

**VirnetX, Inc.**  
**(a development stage enterprise)**

**NOTES TO UNAUDITED FINANCIAL STATEMENTS — (Continued)**

**10. Merger with VirnetX Holding Corporation**

On July 5, 2007 the Company entered into a binding agreement and plan of merger with PASW, Inc., a Delaware corporation, which subsequently changed its name to VirnetX Holding Corporation. Under the terms of the agreement, on July 5, 2007, VirnetX Holding Corporation and the Company consummated a reverse triangular merger in which VirnetX Holding Corporation's wholly-owned acquisition subsidiary merged with and into VirnetX with VirnetX as the surviving corporation to the merger. As a result of the merger, VirnetX became a wholly-owned subsidiary of VirnetX Holding Corporation and the pre-merger stockholders of VirnetX exchanged their shares in VirnetX for shares of common stock of VirnetX Holding Corporation. The key terms of the merger include the following:

- The officers and directors of VirnetX Holding Corporation, except for the chief financial officer, were replaced upon completion of the transaction so that the officers and directors of VirnetX became the officers and directors of VirnetX Holding Corporation;
- The Company's convertible notes payable of \$1,000,000 and \$3,000,000 of funds held in escrow (see Note 4) were converted into VirnetX Holding Corporation common stock in July 2007.
- The Company's convertible notes payable of \$500,000 were converted into VirnetX Holding Corporation common stock in July 2007.
- VirnetX Holding Corporation issued 29,551,398 shares of its common stock and stock options to purchase 1,785,186 shares of common stock from the pre-merger shareholders, convertible note holders and option holders of VirnetX in exchange for 100% of the issued and outstanding capital stock and securities of VirnetX. Additionally, VirnetX Holding Corporation issued to MDB Capital Group, LLC and its affiliates, warrants to purchase an aggregate of 266,667 shares of common stock of VirnetX Holding Corporation pursuant to the provisions of the MDB Service Agreement, which was assumed by VirnetX Holding Corporation from VirnetX in connection with the merger.

**11. Litigation**

On February 15, 2007, the Company filed a complaint against Microsoft Corporation in the United States District Court for the Eastern District of Texas, Tyler Division. Pursuant to the complaint, the Company alleges that Microsoft infringed two of their 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, the Company 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." The Company is seeking both damages, in an amount subject to proof at trial, and injunctive relief. Microsoft answered the amended complaint and asserted counterclaims against the Company 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 attorney's fees and costs. The Company 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. The outcome of this litigation cannot be estimated at this time and hence the financial statements have not been adjusted for this litigation.

**VirnetX, Inc.**  
**(a development stage enterprise)**

**NOTES TO UNAUDITED FINANCIAL STATEMENTS — (Continued)**

**12. Subsequent Events.**

In July 2007, the Company completed the merger in which VirnetX Holding Corporation (formerly, PASW, Inc.) acquired all of the common stock of the Company. In October 2007, PASW, Inc. changed its name to VirnetX Holding Corporation, effected at 1-for-3 reverse stock split and changed its ticker symbol to “VNXH”.

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Board of Directors and Shareholders  
PASW, Inc.

We have audited the accompanying consolidated balance sheets of PASW, Inc. (the "Company") as of December 31, 2006 and 2005, and the related consolidated statements of operations, comprehensive income, changes in shareholders' equity (deficit), and cash flows for the years then ended. 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 auditing 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 consolidated financial statements are free of material misstatement. The Company has determined that it is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit 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 includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of PASW, Inc. as of December 31, 2006 and 2005, and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 11 to the consolidated financial statements, the Company has limited sources of revenue and has incurred significant operating losses in prior years. These factors, among others, raise substantial doubt as to the Company's ability to continue as a going concern. Management's plans concerning these matters are also described in Note 11. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ Farber Hass Hurley & McEwen, LLP

Granada Hills, California  
March 28, 2007



**PASW, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

	December 31,	
	2006	2005
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 306,115	\$ 268,271
Accounts receivable	14,018	17,501
Total current assets	320,133	285,772
Property and equipment-net	1,642	1,826
Other asset	—	3,063
	<u>\$ 321,775</u>	<u>\$ 290,661</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current liabilities</b>		
Accounts payable and accrued expenses	\$ 52,044	\$ 72,311
Total current liabilities	52,044	72,311
<b>Stockholders' equity</b>		
Preferred stock, \$.03 par value; 3,333,333 shares authorized, no shares issued and outstanding	—	—
Common stock, \$.003 par value; 16,666,667 shares authorized; 1,665,800 and 1,665,800 shares issued and outstanding	4,998	4,998
Additional paid-in capital	6,398,754	6,398,754
Accumulated deficit	(6,086,665)	(6,147,083)
Cumulative adjustment for foreign currency translation	(47,356)	(38,319)
Total stockholders' equity	269,731	218,350
	<u>\$ 321,775</u>	<u>\$ 290,661</u>

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

**PASW, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

	For the Years Ended December 31,	
	2006	2005
Revenue		
Royalties and other	\$ 191,287	\$ 213,014
Operating expenses		
Selling, general and administrative	144,365	135,403
Total operating expenses	144,365	135,403
Income from operations	46,922	77,611
Other income	5,035	4,915
Forgiveness of accrued expenses	8,461	37,998
Income from operations before income taxes	60,418	120,524
Provision for taxes	0	0
Net Income	\$ 60,418	\$ 120,524
Net income per common share — Basic and diluted		
Net income per share	\$ 0.03	\$ 0.06
Weighted average common shares basic and diluted	1,665,800	1,665,800

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

PASW, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF  
COMPREHENSIVE INCOME

	For the Years Ended December 31,	
	2006	2005
COMPREHENSIVE INCOME		
Net income	\$ 60,418	\$ 120,524
Foreign currency translation adjustment	(9,037)	(32,079)
Comprehensive income	<u>\$ 51,381</u>	<u>\$ 88,445</u>

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

**PASW, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**  
**FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005**

	Common Stock		Additional Paid-in Capital	Accumulated Deficit	Cumulative Foreign Currency Translation Adjustment	Total Stockholders' Equity
	Shares	Amount				
Balance at January 1, 2005	1,665,800	\$ 4,998	\$ 6,398,754	\$ (6,267,607)	\$ (6,240)	\$ 129,905
Foreign currency translation adjustment					(32,079)	(32,079)
Net income				120,524		120,524
Balance at December 31 2005	1,665,800	4,998	6,398,754	(6,147,083)	(38,319)	218,350
Foreign currency translation adjustment					(9,037)	(9,037)
Net income				60,418		60,418
Balance at December 31, 2006	1,665,800	\$ 4,998	\$ 6,398,754	\$ (6,086,665)	\$ (47,356)	\$ 269,731

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

**PASW, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	For the Years Ended December 31,	
	2006	2005
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income from continuing operations	\$ 60,418	\$ 120,524
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	836	703
(Increase) decrease in assets:		
Accounts receivable	3,483	8,897
Prepaid expenses and other assets		
Increase (decrease) in liabilities:	3,063	2,400
Accounts payable and accrued expenses	(20,267)	(19,693)
Net cash provided by operating activities	<u>47,533</u>	<u>112,831</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchase of fixed assets	(652)	(2,529)
Net cash provided by investing activities	<u>(652)</u>	<u>(2,529)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net cash used in financing activities	<u>0</u>	<u>0</u>
<b>EXCHANGE RATE CHANGES</b>	<u>(9,037)</u>	<u>(32,079)</u>
<b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>	<u>37,844</u>	<u>78,223</u>
<b>CASH AND CASH EQUIVALENTS — BEGINNING</b>	<u>268,271</u>	<u>190,048</u>
<b>CASH AND CASH EQUIVALENTS — ENDING</b>	<u>\$ 306,115</u>	<u>\$ 268,271</u>
<b>SUPPLEMENTAL CASH FLOW INFORMATION:</b>		
Cash paid during the year for:		
Interest paid	\$ Nil	\$ Nil
Income taxes paid	\$ Nil	\$ Nil

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

**PASW, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2006 AND 2005**

**NOTE 1 — SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

***Nature of Operations***

PASW, Inc. (the “Company”) was incorporated in California in November 1992 as a developer and licensor of Internet and Web related software and software development tools. The Company developed and sold software development tools until August 2000. At that time the Company sold all its development activities to another company while maintaining a sales office in Japan. In December 2002 the Company closed the Japanese office but continues to receive royalty income from a single customer in Japan. The remaining administrative operations are conducted principally from an office in the San Francisco Bay Area of Northern California.

***Basis of Consolidation***

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries:

- Network Research Corp. Japan, Ltd. (“NRCJ”);
- Alera Systems, Inc. (“Alera”), formerly iApplianceNet.com (“iAppliance”), a California Corporation;
- Pacific Acquisition Corporation (“PAC”), a California Corporation; and
- PASW Europe Limited (“Europe”), a United Kingdom Corporation.

All references herein to PASW, Inc. or the “Company” include the consolidated results of PASW, Inc. and its subsidiaries. All significant intercompany accounts and transactions were eliminated in consolidation.

Alera, PAC and Europe were inactive in 2006 and 2005.

***Use of Estimates***

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

***Revenue Recognition***

The Company generates all revenue from a royalty license agreement with a single customer in Japan. Generally, income is recognized when earned.

***Cash and Cash Equivalents***

The Company considers all highly liquid investments purchased with original maturities of three months or less to be cash equivalents.

***Concentration of Credit Risk***

The Company places its cash in what it believes to be credit-worthy financial institutions. However, cash balances may exceed FDIC insured levels at various times during the year.

The Company’s accounts receivable are derived from one customer.

***Accounts Receivable***

For financial reporting purposes, PASW, Inc. uses the allowance method of accounting for doubtful accounts. PASW, Inc. performs ongoing credit evaluations of its customers and, if required, maintains an allowance for

**PASW, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

potential credit losses. The allowance is based on an experience factor and review of current accounts receivable. Uncollectible accounts are written off against the allowance accounts when deemed uncollectible. No accounts were deemed uncollectible at December 31, 2006 or 2005.

***Property and Equipment***

Property and equipment are stated at cost. Depreciation is provided for in amounts sufficient to relate the cost of depreciable assets to operations over their estimated service lives, primarily on a straight-line basis. The estimated lives used in determining depreciation are five to seven years for furniture, fixtures and computer equipment. Purchased computer software costs are amortized over five years.

Maintenance and repairs are expensed as incurred; additions and betterments are capitalized. Upon retirement or sale, the cost and related accumulated depreciation of the disposed assets are removed and any resulting gain or loss is recorded.

***Fair Value of Financial Instruments***

The Company's financial instruments consist of cash, accounts receivable, and accounts payable. The carrying amounts of cash, accounts receivable, and accounts payable approximate fair value due to the highly liquid nature of these short-term instruments at December 31, 2006 and 2005.

***Long-Lived Assets***

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate the related carrying amount may not be recoverable. Recovery of assets to be held and used is measured by comparing the carrying amount of the assets to the future net cash flows expected to be generated by the asset. If such assets are considered impaired, the impairment is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less the cost to sell.

***Income Taxes***

Provisions for income taxes are based on taxes payable or refundable for the current year and deferred taxes on temporary differences between the amount of taxable income and pretax financial income and between the tax bases of assets and liabilities and their reported amounts in the financial statements. Deferred tax assets and liabilities are included in the financial statements at currently enacted income tax rates applicable to the period in which the deferred tax assets and liabilities are expected to be realized or settled as prescribed by Statement of Financial Accounting Standards ("SFAS") No. 109, "Accounting for Income Taxes." As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

***Translation of Foreign Currency***

The Company translates foreign currency financial statements of NRCJ in accordance with SFAS 52, "Foreign Currency Translation." Assets and liabilities are translated at current exchange rates and related revenues and expenses are translated at average exchange rates in effect during the period. Resulting translation adjustments are recorded as a separate component in stockholders' equity. Foreign currency transaction gains and losses are included in determining net income.

***Stock-Based Compensation***

PASW, Inc. has adopted SFAS 123(R) "Share-Based Payment" to account for options awarded to employees and directors.

PASW, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

**Recent Accounting Pronouncements**

In March 2005, FASB issued Interpretation No. 47 (“FIN 47”), “*Accounting for Conditional Asset Retirement Obligations*”. FIN 47 clarifies that the term “conditional asset retirement obligation” as used in FASB Statement No. 143, “*Accounting for Asset Retirement Obligation*”, refers to a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. Accordingly, an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. FIN 47 is effective no later than the end of fiscal years ending after December 15, 2005. The adoption of this standard has had no impact on the Company’s consolidated financial statements.

In July 2006, FASB issued Interpretation No. 48 (“FIN 48”), “*Accounting for Uncertainty in Income Taxes — An Interpretation of FASB Statement No. 109*”. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise’s financial statements in accordance with FASB Statement No. 109, and also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 is effective for financial statements issued for fiscal years beginning after December 15, 2006. The adoption of this standard is not expected to have a significant impact on the Company’s consolidated financial statements.

FIN 46(R), “*Consolidation of Variable Interest Entities*”, applies at different dates to different types of enterprises and entities, and special provisions apply to enterprises that have fully or partially applied Interpretation 46 prior to issuance of 46(R). Application of Interpretation 46 or Interpretation 46(R) is required in financial statements of public entities that have interests in variable interest entities or potential variable interest entities commonly referred to as special purpose entities for periods ending after December 15, 2003. Application by public entities (other than small business issuers) for all other types of entities is required in financial statements for periods ending after March 15, 2004. Application by small business issuers to entities other than special purpose entities and by non-public entities to all types of entities is required at various dates in 2004 and 2005. In some instances, enterprises have the option of applying or continuing to apply Interpretation 46 for a short period of time before applying Interpretation 46(R). There is no impact on the Company’s consolidated financial statements.

In September 2006, FASB issued SFAS No. 157, “*Fair Value Measurements*”. SFAS No. 157 provides guidance for using fair value to measure assets and liabilities. It clarifies that for items that are not actively traded, such as certain kinds of derivatives, fair value should reflect the price in a transaction with a market participant, including adjustment for risk, not just the company’s mark-to-model value. Statement No. 157 also requires expanded disclosure of the effect on earnings for items measured using unobservable data. Fair value refers to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts. Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007.

On February 15, 2007, the FASB issued SFAS Statement No. 159, “*The Fair Value Option for Financial Assets and Financial Liabilities*”. This Statement permits companies and not-for-profit organizations to make a one-time election to carry eligible types of financial assets and liabilities at fair value, even if fair value measurement is not required under GAAP. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the effect of the adoption of SFAS No. 159.



**PASW, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**NOTE 2 — PROPERTY AND EQUIPMENT**

Property and equipment consisted of the following:

	December 31,	
	2006	2005
Furniture, fixtures and equipment	\$ 1,826	\$ 2,529
Purchase of furniture	652	0
	2,478	2,529
Less: accumulated depreciation and amortization	836	703
Fixed assets — net	\$ 1,642	\$ 1,826

**NOTE 3 — CAPITAL STOCK**

PASW, Inc. is authorized to issue 3,333,333 shares of Preferred Stock, par value \$.03. Preferred shares may be issued from time to time in one or more series. The number of shares in each series and the designation of each series to be issued shall be determined from time to time by the board of directors of the Company.

**NOTE 4 — STOCK-BASED COMPENSATION**

On April 17, 1998, PASW, Inc. adopted the 1998 Equity Incentive Program (the “Plan”). The Plan expires on December 31, 2008. The Plan provides for granting of the following Stock Awards: (i) Incentive Stock Options, (ii) Non-Statutory Stock Options, (iii) Stock Appreciation Rights, (iv) Stock Bonuses, and (v) Rights to acquire Restricted Stock. Persons eligible to receive Stock Awards are the employees, directors and consultants of the Company and its Affiliates, as defined. Incentive Stock Options may be granted only to employees. Stock awards other than Incentive Stock Options may be granted to all eligible persons.

The maximum term of any options granted is ten years. Vesting requirements may vary, and will be determined by the board of directors. The number of shares reserved for issuance under the Plan is 150,580 shares. At December 31, 2006 the Company had zero outstanding options.

**NOTE 5 — WARRANTS**

On September 18, 2001, PASW, Inc. issued 186,667 fully vested common stock purchase warrants as compensation for services by professionals and consultants. The warrants have an exercise price of \$0.75 per share. The warrants expired on September 19, 2006.

In 2001, the Company also canceled its outstanding employee options and other warrants, and on September 18, 2001 issued 184,558 new fully vested warrants, with an exercise price of \$0.75 per share. The warrants expired on September 19, 2006.

The Company valued the 400,891 warrants issued in 2001 using the Black Sholes option pricing model with the following assumptions: interest rate of 4.5%, life of 5 years, volatility of 145% and expected dividend yield of -0%. The per warrant fair value is \$0.30 and a total expense of \$124,781 was recorded during 2001.

**NOTE 6 — RELATED PARTY TRANSACTIONS**

One officer of the Company also manages the Company and receives management fees. Management fee expense included in the statement of operations totaled \$30,000 in 2006 and 2005.

The Company occupies facilities in California provided by the same officer at no charge.

**PASW, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**NOTE 7 — SEGMENT INFORMATION**

All of the Company's 2006 and 2005 sales were in Japan.

**NOTE 8 — INCOME TAXES**

The provision for income taxes consists of the following:

	December 31,	
	2006	2005
Current	\$ 0	\$ 0

The reconciliation of the effective income tax rate to the Federal statutory rate is as follows:

	December 31,	
	2006	2005
Federal income tax rate	35.0%	35.0%
Surtax exemption	(10.0)	(10.0)
Effect of valuation allowance	(25.0)	(25.0)
State taxes	0	0
Effective income tax rate	0%	0%

At December 31, 2006, the Company had a net carryforward operating loss of approximately \$4,480,000. A valuation allowance equal to the tax benefit for deferred taxes was established due to the uncertainty of realizing the benefits of the tax carryforward. Any merger or acquisition by another company would significantly reduce utilization of the net operating loss carryforward.

Deferred tax assets and liabilities reflect the net tax effect of temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and amounts used for income tax purposes. Significant components the Company's deferred tax assets (liabilities) are as follows:

	December 31,	
	2006	2005
Non-current deferred tax assets (liabilities):		
Loss carryforwards	\$ 1,000,000	\$ 1,100,000
Less: valuation allowance	(1,000,000)	(1,100,000)
Net deferred tax assets (liabilities)	\$ 0	\$ 0

The net operating loss carryforwards begin to expire in 2019 and expire by 2026.

**NOTE 9 — EARNINGS PER SHARE**

Securities that could potentially dilute basic earnings per share in the future, were not included in the computation of diluted earnings per share because their effect would have been antidilutive, are as follows:

	December 31,	
	2006	2005
Warrants and Options	0	400,891
Total shares	0	400,891

PASW, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

**NOTE 10 — ACCRUED EXPENSES**

During 2001 the Company accrued certain expenses in anticipation of possible charges for goods and services. The charges did not materialize; therefore in 2005 the Company reversed certain accruals. In 2006, the Company reversed certain other accruals.

**NOTE 11 — GOING CONCERN**

The accompanying financial statements were prepared in conformity with generally accepted accounting principles, which contemplate continuation of the Company as a going concern. Although the Company had positive cash flows in 2006 and 2005, it had net operating losses of \$6,086,665 since inception. The Company's only operating subsidiary NRCJ sold all its revenue producing assets in 2003 and there is no assurance that the remaining royalty income is sufficient to allow the Company to continue operations. These factors raise substantial doubt about the Company's ability to continue as a going concern. In view of the matters described above, the Company is dependent on its ability to raise sufficient capital to fund its working capital requirements until the Company can generate sufficient sales volume to cover its operating expenses. As of December 31, 2006, the Company is actively seeking a reverse merger candidate.

VIRNETX HOLDING CORPORATION  
CONDENSED CONSOLIDATED BALANCE SHEETS

	June 30, 2007	December 31, 2006
(Unaudited)		
<b>ASSETS</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 72,336	\$ 306,115
Accounts receivable, net of allowance of \$0 and \$0	32,032	14,018
<b>Total current assets</b>	<b>104,368</b>	<b>320,133</b>
Property and equipment, less accumulated depreciation of \$418 and \$703	1,224	1,642
<b>Total assets</b>	<b>\$ 105,592</b>	<b>\$ 321,775</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current liabilities:</b>		
Accounts payable and accrued expenses	\$ 45,171	\$ 52,044
<b>Total current liabilities</b>	<b>45,171</b>	<b>52,044</b>
<b>Commitments and contingencies</b>		
<b>Stockholders' equity:</b>		
Preferred stock, par value \$.00003 per share, 3,333,333 shares authorized; no shares outstanding	0	0
Common stock, par value \$.00003 per share, 66,666,667 shares authorized; 1,665,800 shares issued and outstanding	50	50
Additional paid-in capital	6,403,702	6,403,702
Accumulated deficit	(6,291,391)	(6,086,665)
Cumulative adjustment for currency translation	(51,940)	(47,356)
<b>Total stockholders' equity</b>	<b>60,421</b>	<b>269,731</b>
	<b>\$ 105,592</b>	<b>\$ 321,775</b>

See accompanying notes to condensed consolidated financial statements.

VIRNETX HOLDING CORPORATION  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	For the Three Months Ended	
	June 30, 2007	June 30, 2006
	(Unaudited)	
Revenue — Royalties	\$ 64,827	\$ 75,968
Expenses — Selling, general and administrative	224,579	33,124
Income (loss) from operations	(159,752)	42,844
Income taxes	0	0
Net income (loss)	\$ (159,752)	\$ 42,844
Net income (loss) per common share: Basic and Diluted	\$ (0.09)	\$ 0.03
Weighted average common stock shares outstanding Basic and Diluted	1,665,800	1,665,800

See accompanying notes to condensed consolidated financial statements.

VIRNETX HOLDING CORPORATION  
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

	For the Three Months Ended	
	June 30, 2007	June 30, 2006
	(Unaudited)	
Net income (loss)	\$ (159,752)	\$ 42,844
Other comprehensive income:		
Foreign currency translation adjustment	(4,382)	1,016
Comprehensive income (loss)	<u>\$ (164,134)</u>	<u>\$ 43,860</u>

See accompanying notes to condensed consolidated financial statements.

VIRNETX HOLDING CORPORATION  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	For the Six Months Ended	
	June 30, 2007	June 30, 2006
	(Unaudited)	
Revenue — Royalties	\$ 114,381	\$ 121,017
Expenses — Selling, general and administrative	319,107	63,440
Income (loss) from operations	(204,726)	57,577
Income taxes	0	0
Net income (loss)	\$ (204,726)	\$ 57,577
Net income (loss) per common share: Basic and Diluted	\$ (0.12)	\$ 0.03
Weighted average common stock shares outstanding Basic and Diluted	1,665,800	1,665,800

See accompanying notes to condensed consolidated financial statements.

VIRNETX HOLDING CORPORATION  
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

	For the Six Months Ended	
	June 30, 2007	June 30, 2006
	(Unaudited)	
Net income (loss)	\$ (204,726)	\$ 57,577
Other comprehensive income:		
Foreign currency translation adjustment	(4,584)	1,278
Comprehensive income (loss)	<u>\$ (209,310)</u>	<u>\$ 58,855</u>

See accompanying notes to condensed consolidated financial statements.



VIRNETX HOLDING CORPORATION  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the Six Months Ended	
	June 30, 2007	June 30, 2006
	(Unaudited)	
<b>Cash flows from operating activities:</b>		
Net income (loss)	\$ (204,726)	\$ 57,577
Depreciation	418	418
Adjustments to reconcile net loss to net cash used in operating activities:		
(Increase) decrease in assets:		
Accounts receivable	(18,014)	(13,439)
Increase (decrease) in liabilities:		
Accounts payable and accrued expenses	(6,873)	(20,100)
Net cash provided by (used in ) operating activities	<u>(229,195)</u>	<u>24,456</u>
Cash flows from investing activities		
Purchase of fixed assets	—	(652)
Cash flows from financing activities		
Effect of exchange rate changes on cash	(4,584)	1,539
Net increase (decrease) in cash	(233,779)	25,343
Cash — Beginning	306,115	268,271
Cash — Ending	<u>\$ 72,336</u>	<u>\$ 293,614</u>

Supplemental non-cash investing and financing activities: None

See accompanying notes to condensed consolidated financial statements

**VIRNETX HOLDING CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(UNAUDITED)**

**General**

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted. Results of operations for the interim periods presented are not necessarily indicative of results which may be expected for any other interim period or for the year as a whole. The information contained in this Form 10-QSB should be read in conjunction with audited financial statements and related notes for the year ended 2006 which are contained in the Company's Annual Report on Form 10-KSB filed with the Securities and Exchange Commission (the "SEC") on April 2, 2007.

The accompanying unaudited interim financial statements include all adjustments (consisting of normal recurring accruals) which are, in the opinion of management, necessary to a fair statement of the results for the interim periods presented. These financial statements should be read in conjunction with the financial statements and related notes thereto on our Annual Report on Form 10-KSB for the year ended December 31, 2006.

These financial statements have been prepared under the assumption that we will be able to continue as a going concern. In the event that we are unable to achieve or sustain profitability or are otherwise unable to secure external financing, we may not be able to meet our obligations as they come due, raising substantial doubts as to our ability to continue as a going concern. Any such inability to continue as a going concern may result in our security holders losing their entire investment. Our financial statements, which have been prepared in accordance with generally accepted accounting principles, contemplate that we will continue as a going concern and do not contain any adjustments that might result if we were unable to continue as a going concern. Our historical net losses and our 2007 cash flow from operations deficiency raise substantial doubt as to our ability to continue as a going concern. Also, changes in our operating plans, our existing and anticipated working capital needs, the acceleration or modification of our expansion plans, lower than anticipated revenues, increased expenses, potential acquisitions or other events will all affect our ability to continue as a going concern.

**Nature of Operations**

VirnetX Holding Corporation (formerly, PASW, Inc.) ("*VirnetX Holding Corporation*" "*We*" "*Our*" or the "*Company*") was incorporated in the State of California in November 1992. We were incorporated in the State of Delaware in April 2007 and on May 30, 2007 we filed a certificate of merger in Delaware pursuant to which we changed our domicile from California to Delaware. From our inception until January 2003, we were engaged in the business of developing and licensing software that enabled Internet and web based communications. As of January 31, 2003, we had sold all of our operating assets, and since such time our only source of revenue has been nominal royalties payable to us through our wholly-owned Japanese subsidiary, Network Research Corp. Japan, Ltd. ("NRCJ") pursuant to the terms of a single license agreement.

The Company has spent no funds on research and development in the last four fiscal years.

As of June 30, 2007 the Company has no full-time employees. The Company pays one of its officers a management fee for services rendered to maintain administrative operations.

**Use of Estimates**

Preparing financial statements in conformity with generally accepted accounting principles 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 reporting period. Actual results could differ from those estimates.

**VIRNETX HOLDING CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**Revenue Recognition**

We are a licensor of software and generate revenue primarily from sales of our licensed software to one customer. Revenue is recognized when the customer remits royalties to us each month based on the units sold by the customer.

**Translation of Foreign Currency**

We translate foreign currency financial statements of NRCJ in accordance with SFAS 52, "Foreign Currency Translation." Assets and liabilities are translated at current exchange rates and related revenues and expenses are translated at average exchange rates in effect during the period. Resulting translation adjustments are recorded as a separate component in stockholders' equity. Foreign currency transaction gains and losses are included in determining net income.

**Provision for income taxes**

We have not provided a benefit for income tax on our net loss for the three or six months ended June 30, 2007, because we cannot conclude that it is more likely than not that we will generate sufficient future taxable income to realize such a benefit. We did not make a provision for income tax expense for the three or six months ended June 30, 2006, because we have a net operating loss carryforward at the end of 2005.

**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 ended June 30, 2007 we did not have any options, warrants or other dilutive instruments outstanding.

**Subsequent Event — Merger with VirnetX**

On July 5, 2007, we completed a merger between VirnetX Acquisition, Inc. (our subsidiary), and VirnetX, Inc. ("VirnetX") a Delaware corporation in the development stage that is engaged in software development for secure real time communications.

As a result of the merger:

- VirnetX became our wholly owned subsidiary;
- The officers and directors of VirnetX became the officers and directors of VirnetX Holding Corporation;
- VirnetX Acquisition, Inc. ceased its existence.
- We issued 23,535,398 shares of common stock to shareholders of VirnetX;
- We issued 6,016,000 shares of common stock to convertible bridge note holders in exchange for \$3 million in cash and full satisfaction of a \$1.5 million obligation to such convertible bridge note holders;
- We issued options to purchase 1,743,670 shares of our common stock to holders of options of VirnetX; and
- We issued warrants to purchase 266,667 shares of our common stock pursuant to the merger agreement.

Stockholders of VirnetX Holding Corporation who prior to the merger, owned 100% of our common stock own approximately 5% of our common stock as of the date of the VirnetX merger (on a fully diluted basis, after giving effect to the exercise and conversion of all options, warrants and other rights to acquire shares of our common stock). The shareholders, option holders and warrant holders of VirnetX, as well as those providing the additional equity funding, own the balance of the outstanding capital stock of the Company as of the date of the VirnetX merger.

**VirnetX, Inc. and VirnetX Holding Corporation**  
**(a development stage enterprise)**

**PRO FORMA COMBINED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

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**Introduction**

On June 12, 2007 VirnetX, Inc., a Delaware corporation (“VirnetX”), entered into a binding agreement and plan of merger with VirnetX Holding Corporation, a Delaware corporation (formerly, PASW, Inc.). Under the terms of the agreement, on July 5, 2007, VirnetX Holding Corporation and VirnetX consummated a reverse triangular merger in which VirnetX Holding Corporation’s wholly-owned acquisition subsidiary merged with and into VirnetX with VirnetX as the surviving corporation to the merger. As a result of the merger, VirnetX became a wholly-owned subsidiary of VirnetX Holding Corporation and the pre-merger stockholders of VirnetX exchanged their shares in VirnetX for shares of common stock of VirnetX Holding Corporation. At the closing date of the merger, VirnetX security holders owned approximately 95% of the combined company on a fully-diluted basis. VirnetX directors and executive management constituted a majority of the combined company’s board of directors and executive management, respectively. As a result, VirnetX is deemed to be the acquiring company for accounting purposes, and the merger transaction will be accounted for as a reverse merger and a recapitalization. The financial statements of the combined entity reflect the historical results of VirnetX prior to the merger, and do not include the historical financial results of VirnetX Holding Corporation prior to the merger except for those operations of VirnetX Holding Corporation expected to continue after the merger. Stockholders’ equity and earnings per share of the combined entity will be retroactively restated to reflect the number of shares of common stock received by VirnetX security holders in the merger, after giving effect to the difference between the par values of the capital stock of VirnetX and VirnetX Holding Corporation, offset by additional paid-in capital.

The following unaudited pro forma combined financial statements have been prepared to give effect to the merger of VirnetX and VirnetX Holding Corporation which, in accordance with accounting principles generally accepted in the United States, is considered a reverse acquisition of assets and a recapitalization with VirnetX deemed to be the acquiror of VirnetX Holding Corporation. It is assumed that VirnetX Holding Corporation does not meet the definition of a business in accordance with Statement of Financial Accounting Standards, No. 141, “Business Combinations”, (“SFAS 141”), and Emerging Issues Task Force 98-3, “Determining Whether a Non-monetary Transaction Involves Receipt of Productive Assets or of a Business”, (“EITF 98-3”).

For accounting purposes, VirnetX Holding Corporation is being viewed as a publicly-held shell company because it had approximately \$72,000 of cash and no other material assets or liabilities at the time of the closing of the merger. VirnetX security holders own approximately 95% of the combined company on a fully-diluted basis post merger and VirnetX directors and executive management constitute a majority of the combined company’s board of directors and executive management, respectively. Based on the above and in accordance with accounting principles generally accepted in the United States, the merger is considered to be a reverse acquisition and recapitalization; and as such the cost of the proposed merger is measured as net assets acquired, and goodwill will not be recognized.

The actual amounts recorded pursuant to the merger may differ materially from the information presented in these unaudited pro forma combined condensed consolidated financial statements as a result of:

- the impact of any sale of all or part of the operating assets of VirnetX Holding Corporation,
- cash cost of VirnetX Holding Corporation’s operations between the signing of the merger agreement and the closing of the merger,
- the timing of completion of the merger,
- the cost of liquidation of any operating assets should VirnetX Holding Corporation or VirnetX fail to divest of such assets or liabilities, and
- other changes in VirnetX Holding Corporation’s assets that occur prior to completion of the merger, which could cause material differences in the information presented below.

The unaudited pro forma combined condensed consolidated financial statements presented below are based on the historical financial statements of VirnetX and VirnetX Holding Corporation, adjusted to give effect to the merger. The pro forma adjustments are described in the accompanying notes presented on the following pages.

The unaudited pro forma combined condensed consolidated balance sheet assumes that the merger was completed as of June 30, 2007. The unaudited pro forma combined condensed consolidated statement of operations for the year ended December 31, 2006 and the six months ended June 30, 2007 assume that the merger was completed as of January 1, 2006.

The unaudited pro forma combined condensed consolidated financial information is presented for illustrative purposes only and is not necessarily indicative of the financial position or results of operations that would have actually been reported had the merger occurred at the dates stated above, nor is it necessarily indicative of future financial position or results of operations. The unaudited pro forma combined condensed consolidated financial information has been derived from, and should be read, in conjunction with the historical consolidated financial statements and related notes of VirnetX and VirnetX Holding Corporation which are included in this Registration Statement on Form SB-2.

**VirnetX, Inc. and VirnetX Holding Corporation**  
(a development stage enterprise)

**PRO FORMA COMBINED CONDENSED CONSOLIDATED  
BALANCE SHEET**

	As of June 30, 2007			As of June 30, 2007 Pro Forma As Adjusted
	VirnetX	VirnetX Holding Corporation	Pro Forma Adjustments (Unaudited)	
<b>ASSETS</b>				
Current assets:				
Cash and cash equivalents	\$ 86,835	\$ 72,336	\$ 3,000,000 C	\$ 3,159,171
Accounts receivable	—	32,032	—	32,032
Prepaid expenses and other current assets	488,165	—	(72,336) C	415,829
Assets held for sale	—	—	1,224 A	1,224
Total current assets	575,000	104,368	2,928,888	3,608,256
Property and equipment, net	28,742	1,224	(1,224) A	28,742
Other assets	1,244	—	—	1,244
Total assets	<u>\$ 604,986</u>	<u>\$ 105,592</u>	<u>\$ 2,927,664</u>	<u>\$ 3,638,242</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)</b>				
Current liabilities:				
Accounts payable	\$ 897,297	\$ 45,171	\$ —	\$ 942,468
Accrued expenses	—	—	500,000 B	500,000
Notes payable	50,000	—	—	50,000
Convertible notes payable	1,500,000	—	(1,500,000) C	—
Total current liabilities	2,447,297	45,171	(1,000,000)	1,492,468
Commitments and contingencies:				
Stockholders' equity (deficit):				
Preferred stock	1,377,625	—	(1,377,625) C	—
Common stock	426	4,998	88,055 I	93,479
Additional paid-in capital	1,075,368	6,398,754	(72,336) C	6,848,025
			3,000,000 C	
			2,877,625 C	
			(6,343,331) D	
			(88,055) I	
Accumulated deficit	(4,295,730)	(6,291,391)	6,291,391 D	(4,795,730)
			(500,000) B	
Accumulated comprehensive (loss)	—	(51,940)	51,940 D	—
Total stockholders' equity (deficit)	(1,842,311)	60,421	3,927,664	2,145,774
Total liabilities and stockholders' equity (deficit)	<u>\$ 604,986</u>	<u>\$ 105,592</u>	<u>\$ 2,927,664</u>	<u>\$ 3,638,242</u>

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

**VirnetX, Inc. and VirnetX Holding Corporation**  
(a development stage enterprise)

**PRO FORMA COMBINED CONDENSED CONSOLIDATED  
STATEMENT OF OPERATIONS**

	Six Months Ended June 30, 2007		Pro Forma Adjustments (Unaudited)	Six Months Ended June 30, 2007 Pro Forma As Adjusted
	VirnetX	VirnetX Holding Corporation		
Revenues:				
Royalties	\$ —	\$ 114,381	\$ — E	\$ 114,381
Operating expenses:				
Research and development	268,178	—	—	268,178
General and administrative	1,698,247	319,107	(288,212) F	2,229,142
			500,000 B	
Total operating expenses	1,966,425	319,107	211,788	2,497,320
Loss from operations	(1,966,425)	(204,726)	(211,788)	(2,382,939)
Interest and other income (expense), net	(45,488)	—	45,488 J	—
Net loss before income taxes	(2,011,913)	(204,726)	(166,300)	(2,382,939)
Income taxes	—	—	—	—
Net loss	\$ (2,011,913)	\$ (204,726)	\$ (166,300)	\$ (2,382,939)
Net income (loss) per share:				
Basic and diluted	\$ (1.07)	\$ (0.12)	\$ —	\$ (0.08)
Weighted average common stock:				
Shares outstanding				
Basic	1,886,333	1,665,800	21,607,549G 6,000,000H	31,159,682

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

**VirnetX, Inc. and VirnetX Holding Corporation**  
(a development stage enterprise)

**PRO FORMA COMBINED CONDENSED CONSOLIDATED  
STATEMENT OF OPERATIONS**

	Year Ended December 31, 2006			Year Ended December 31, 2006
	VirnetX	VirnetX Holding Corporation (Unaudited, derived from audited financial statements)	Pro Forma Adjustments	Pro Forma As Adjusted
<b>Revenues:</b>				
Royalties	\$ —	\$ 191,287	\$ —E	\$ 191,287
<b>Operating expenses:</b>				
Research and development	554,187	—	—	554,187
General and administrative	853,488	144,365	(136,205)F	861,648
Total operating exepnses	1,407,675	144,365	(136,205)	1,415,835
Loss from operations	(1,407,675)	46,922	136,205	(1,224,548)
Interest and other income (expense), net	6,336	5,035	—	11,371
Forgiveness of accrued expenses	—	8,461	(8,461)F	—
Net loss before income taxes	(1,401,339)	60,418	127,744	(1,213,177)
Income taxes	—	—	—	—
Net loss	\$ (1,401,339)	\$ 60,418	\$ 127,744	\$ (1,213,177)
<b>Net income (loss) per share:</b>				
Basic and diluted	\$ (0.74)	\$ 0.04	\$ —	\$ (0.04)
<b>Weighted average common stock:</b>				
Shares outstanding				
Basic	1,886,333	1,665,800	21,607,549G 6,000,000H	31,159,682

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



**VirnetX, Inc. and VirnetX Holding Corporation**  
**(a development stage enterprise)**

**NOTES TO PRO FORMA COMBINED CONDENSED CONSOLIDATED**  
**FINANCIAL STATEMENTS**  
**(Unaudited)**

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**1. Basis of Presentation**

On April 18, 2007, stockholders owning a majority of the outstanding shares of VirnetX Holding Corporation acted by written consent to approve a merger which changed VirnetX Holding Corporation's state of incorporation from the State of California to the State of Delaware.

On June 12, 2007, VirnetX Holding Corporation entered into the merger agreement with VirnetX, the terms of which provide for a change in control of VirnetX Holding Corporation. On July 5, 2007 the merger was consummated. As part of the merger, VirnetX Holding Corporation's wholly-owned acquisition subsidiary, VirnetX Acquisition, Inc. merged with and into VirnetX, with VirnetX surviving the merger and becoming PASW's wholly-owned subsidiary thereafter. Additionally, the securityholders of VirnetX collectively exchanged their (i) shares of capital stock and convertible notes for shares of VirnetX Holding Corporation's common stock; (ii) options to purchase shares of capital stock of VirnetX for similar options to purchase shares of VirnetX Holding Corporation's common stock and (iii) warrant rights for a warrant to purchase shares of VirnetX Holding Corporation's common stock. The existing securityholders of VirnetX owned shares of VirnetX Holding Corporation's common stock and options or warrants to purchase shares of VirnetX Holding Corporation's common stock, collectively constituting approximately 95% of our issued and outstanding capital stock (assuming the exercise of all outstanding options) immediately after the consummation of the merger.

More specifically, upon the consummation of the merger:

- in exchange for each share of common stock, par value \$0.00003 per share of VirnetX outstanding as of immediately prior to the consummation of the merger, VirnetX Holding Corporation issued to such VirnetX stockholders approximately 12.45479 shares of VirnetX Holding Corporation common stock, for an aggregate of approximately 23,535,398 shares of VirnetX Holding Corporation common stock;
- upon conversion of and in exchange for the principal and accrued interest amount of convertible notes outstanding as of immediately prior to the consummation of the merger VirnetX Holding Corporation issued to such convertible note holders VirnetX Holding Corporation an aggregate of 6,016,000 shares of VirnetX Holding Corporation common stock;
- in exchange for each VirnetX option outstanding as of immediately prior to the consummation of the merger PASW issued to VirnetX option holders an option to purchase 12.45479 shares of VirnetX Holding Corporation common stock, for options exercisable for an aggregate of 1,743,670 shares of VirnetX Holding Corporation common stock, at a per share exercise price equal to the exercise price applicable to each such VirnetX option divided by 12.45479, and upon such other terms and conditions provided with respect to such VirnetX option; and
- VirnetX Holding Corporation issued a warrant to purchase 266,667 shares of VirnetX Holding Corporation's common stock to MDB Capital Group, Incorporated ("MDB") pursuant to an Advisory Services Agreement between MDB and VirnetX, as amended to date, with an exercise price of \$0.75 per share. The obligation to issue this warrant was assumed by VirnetX Holding Corporation in the merger.

Upon the closing of the merger and the conversion of all of the securities described above, VirnetX became a wholly-owned subsidiary of VirnetX Holding Corporation.

For accounting purposes, VirnetX Holding Corporation is being viewed as a publicly-held shell company because (i) it had approximately \$72,000 of cash and no other material assets or liabilities at the time of closing the merger, (ii) at the closing date of the merger, VirnetX security holders owned approximately 95% of the combined company on a fully-diluted basis, (iii) VirnetX directors and executive management constituted a majority of the combined company's board of directors and executive management, respectively. Additionally, due to the

**VirnetX, Inc. and VirnetX Holding Corporation**  
**(a development stage enterprise)**

**NOTES TO PRO FORMA COMBINED CONDENSED CONSOLIDATED**  
**FINANCIAL STATEMENTS — (Continued)**

foregoing, VirnetX will be deemed to be the acquiring company for accounting purposes and the merger is considered to be a reverse acquisition and recapitalization. As a result, the cost of the proposed merger is measured as net assets acquired and goodwill will not be recognized.

**2. Pro Forma Adjustments**

A) To reflect the reclassification of certain VirnetX Holding Corporation operating assets as assets held for sale and assets that are to be assumed by VirnetX at the close of the merger.

B) To reflect the accrual of estimated costs of \$500,000 incurred after June 30, 2007 by VirnetX and VirnetX Holding Corporation in connection with the consummation of the merger. Merger costs include fees payable for investment banking services, legal, accounting, printing, and other consulting services.

C) To reflect the exchange of all outstanding common stock of VirnetX and convertible notes payable for an estimated 29,500,000 shares of VirnetX Holding Corporation common stock, par value of \$0.003, which represents the total of (i) 23,535,398 shares of VirnetX Holding Corporation common stock that were issued to the stockholders of VirnetX at the closing of the merger, which equals approximately twelve times the number of fully diluted shares of VirnetX Holding Corporation common stock issued and outstanding immediately prior to the closing of the merger, and (ii) 6,016,000 shares of VirnetX Holding Corporation common stock that were issued to the holders of convertible debt based on the written consent to convert the debt to stock upon the merger. The adjustments also include the release of \$3,000,000 held in escrow from San Gabriel Fund LLC that were released as part of the reverse merger in exchange for VirnetX Holding Corporation common stock. In addition the adjustments include \$72,336 of deferred merger expenses that will be reclassified to additional paid-in capital upon closing of the reverse merger.

D) To reflect the elimination of VirnetX Holding Corporation's common stock, additional paid in capital, accumulated comprehensive loss and accumulated deficit.

E) Royalties paid to the Company pursuant to a contract that is renewed annually, but may be cancelled by either party at the renewal date, will continue until December 31, 2007, but are not assured beyond this date.

F) To reflect the elimination of expenses of VirnetX Holding Corporation, excluding costs related to being a public company, expenses related to the merger and the expenses that are expected to remain in the consolidated company.

G) Holders of VirnetX common stock (including shares of VirnetX preferred stock converted to VirnetX common stock immediately prior to the closing of the merger) will receive 12.45479 newly-issued shares of VirnetX Holding Corporation common stock for each share of VirnetX common stock exchanged in connection with the merger.

H) The holders of the convertible debt of VirnetX, in an aggregate principal and accrued interest amount of \$4,512,000, will receive a total of 6,016,000 shares of VirnetX Holding Corporation common stock in exchange for the entire aggregate principal amount of such convertible debt and shall be paid any and all interest accrued thereon in cash.

I) To adjust common stock and additional paid-in capital for common shares outstanding at June 30, 2007 at the par value of \$0.003 per share.

J) To eliminate interest expense paid on the convertible notes payable that were converted to common stock when the merger closed.

PRELIMINARY PROSPECTUS

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# VIRNETX HOLDING CORPORATION

3,000,000 Shares  
Common Stock

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## Gilford Securities Incorporated

We have not authorized any dealer, salesperson or other person to give you written information other than this prospectus or to make representations as to matters not stated in this prospectus. You must not rely on unauthorized information. This prospectus is not an offer to sell these securities or our solicitation of your offer to buy these securities in any jurisdiction where that would not be permitted or legal. Neither the delivery of this prospectus nor any sales made hereunder after the date of this prospectus shall create an implication that the information contained herein or the affairs of the company have not changed since the date of this prospectus.

Until , 2007 (25 days after the date of this prospectus), all dealers that buy, sell or trade the common stock offered hereby, whether or not participating in this offering, may be required to deliver a prospectus. This is in addition to the dealers' obligation to deliver a prospectus when acting as an underwriter and with respect to their unsold allotments or subscriptions.

, 2007

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The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and it is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

**SUBJECT TO COMPLETION, DATED NOVEMBER 5, 2007**

**PRELIMINARY PROSPECTUS**

# **VIRNETX HOLDING CORPORATION**

**5,600,000 Shares  
Common Stock**

The security holders named in this prospectus may sell for their accounts 5,600,000 shares of our common stock, including 266,667 shares of common stock underlying warrants held by the selling stockholders.

The securities described in this prospectus are not being sold by any underwriter. VirnetX Holding Corporation will not receive any proceeds from the sale of these securities, except in connection with the exercise of warrants, in which case we will receive the exercise price thereof.

Our common stock is quoted on the OTC Bulletin Board under the symbol "VNXH." On October 30, 2007, the last reported sales price of our common stock as reported on the OTC Bulletin Board was \$5.00 per share (on a post-split basis). We have applied for listing on the Nasdaq Capital Market to take effect prior to the closing of the offering.

**Investing in our common stock involves a high degree of risk. Please carefully consider the "Risk Factors" beginning on page 5 of this prospectus.**

**NEITHER THE SECURITIES AND EXCHANGE COMMISSION NOR ANY STATE SECURITIES COMMISSION HAS APPROVED OR DISAPPROVED OF THE SHARES OF COMMON STOCK OR PASSED ON THE ADEQUACY OR ACCURACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.**

The date of this prospectus is \_\_\_\_\_, 2007

#### SALE OF SECURITIES DESCRIBED IN THIS PROSPECTUS

The sale of the securities described in this prospectus may be made from time to time in transactions, which may include block transactions by or for the account of the holders, in the over-the-counter market or in negotiated transactions through a combination of these methods of sale or otherwise. Sales may be made at fixed prices which may be changed, at market prices prevailing at the time of sale, or at negotiated prices.

A post-effective amendment to the registration statement that includes this prospectus must be filed and declared effective by the Securities and Exchange Commission before a holder may:

- sell any securities described in this prospectus according to the terms of this prospectus either at a fixed price or a negotiated price, either of which is not the prevailing market price,
- sell securities described in this prospectus in a block transaction to a purchaser who resells,
- pays compensation to a broker-dealer that is other than the usual and customary discounts, concessions or commissions, or
- makes any arrangements, either individually or in the aggregate, that would constitute a distribution of the securities described in this prospectus.

Information contained in this prospectus, except for the cover page, the back cover page and the information under the heading "Selling security holders", is a part of that separate prospectus relating to a concurrent initial public offering by VirnetX Holding Corporation. This prospectus contains information, including all information relating to the concurrent underwritten offering and the underwriter, that may not be pertinent to the sale of the securities offered in this prospectus by the named holders.

Except as noted below, the securities described in this prospectus may be sold by the named holders or their transferees starting on the date of this prospectus. The named holders have agreed with VirnetX Holding Corporation and with Gilford Securities Incorporated not to sell any of their securities for a period of 12 months from the date of this prospectus without the prior written consent of the underwriter; provided, however, that if the average closing price per share of the Company's common stock exceeds 150% of the public offering price of the shares to be offered for 15 consecutive trading days during the lock-up period, the shares of common stock held by the San Gabriel group of investors shall be released from the lock-up by Gilford Securities Incorporated. Sales of these securities may depress the price of the common stock in any market that may develop for these securities.

**SELLING SECURITY HOLDERS**

This prospectus relates to the sale of 5,600,000 shares of common stock of VirnetX Holding Corporation by the security holders named below, including 266,667 shares of common stock underlying warrants held by the selling stockholders. VirnetX Holding Corporation will not receive any of the proceeds of the sale of the securities by the selling security holders, except in connection with the exercise of warrants, in which case we will receive the exercise price thereof.

The following table sets forth information regarding the shares of common stock owned beneficially as of October 31, 2007 on a post-split basis by each selling security holder. The selling security holders are not required, and may choose not, to sell any of their shares of common stock. The selling security holders have agreed with VirnetX Holding Corporation and with Gilford Securities Incorporated not to sell any of their securities for a period of 12 months from the date of this prospectus without the prior written consent of the underwriter; provided, however, that if the average closing price per share of the Company's common stock exceeds 150% of the public offering price of the shares to be offered for 15 consecutive trading days during the lock-up period, the shares of common stock held by the San Gabriel group of investors shall be released from the lock-up by Gilford Securities Incorporated. None of the selling security holders is an officer, director or other affiliate of VirnetX Holding Corporation except as indicated below.

<u>Name of Selling Securityholder</u>	<u>Shares Owned Prior to Offering</u>	<u>Shares Being Offered</u>	<u>Shares Owned After Offering</u>
San Gabriel Fund, LLC*†	1,600,000	1,600,000	—
JMW Fund, LLC†	1,200,000	1,200,000	—
John P. McGrain†	1,120,000	1,120,000	—
John P. McGrain, SEP IRA†	26,666	26,666	—
John P. McGrain, 401K†	26,667	26,667	—
Aaron A. Grunfeld†**	86,667	86,667	—
Underwood Family Partners, LTD†	16,667	16,667	—
The Elevation Fund, LLC†	266,667	266,667	—
The West Hampton Special Situations Fund, LLC†	200,000	200,000	—
The Kirby Enterprise Fund, LLC†	133,333	133,333	—
Thomas E. Manoogian†	16,667	16,667	—
Patrick Reidy†	53,333	53,333	—
Arthur Kassoff†	23,333	23,333	—
Lisa Kirby, custodian for Kelsey Kirby†	44,444	44,444	—
Lisa Kirby, custodian for Charles Kirby†	44,444	44,444	—
Chad K. Kirby†	44,445	44,445	—
Kearney Properties, LLC†	100,000	100,000	—
Amy Atkinson†	3,333	3,333	—
Charles F. Kirby, Roth IRA†	26,667	26,667	—
Kearney Holdings, LLC†	333,333	333,333	—
Christopher A. Marlett††	119,167	119,167	—
Anthony DiGiandomenico††	75,833	75,833	—
Dyana Marlett††	21,667	21,667	—
David Byrne††	16,667	16,667	—
<b>Total</b>	<b>5,600,000</b>	<b>5,600,000</b>	

\* Indicates a 5% stockholder.

† Indicates a member of the San Gabriel group of investors.

†† All of this holder's shares are shares of common stock underlying a warrant.

\*\* 33,333 of this holder's shares are shares of common stock underlying a warrant.

The selling security holders indicated in the table above as members of the San Gabriel group of investors received their shares of common stock of VirnetX Holding Corporation pursuant to the conversion of convertible bridge notes upon consummation of the merger between VirnetX, Inc. and VirnetX Holding Corporation.

Christopher A. Marlett and Anthony DiGiandomenico are registered broker-dealers affiliated with MDB Capital Group LLC. David Byrne is a service provider to MDB Capital Group LLC. Anthony DiGiandomenico and MDB Capital Group LLC were among the founding group of stockholders that received shares of common stock of VirnetX, Inc. at inception. In addition, MDB Capital Group LLC had an investment banking relationship with VirnetX, Inc. as compensation for which it was given a right to receive a warrant to purchase shares of the common stock of VirnetX Holding Corporation upon consummation of the merger between VirnetX Holding Corporation and VirnetX, Inc. The right to receive this warrant was assigned to the individual selling security holders indicated in the table above as holders of shares underlying a warrant.

With respect to the selling security holders that are entities:

- Justin Yorke has sole voting and investment power with respect to the shares of common stock of VirnetX Holding Corporation held by San Gabriel Fund, LLC and JMW Fund, LLC;
- John P. McGrain has sole voting and investment power with respect to the shares of common stock of VirnetX Holding Corporation held by the John P. McGrain, SEP IRA and the John P. McGrain, 401K;
- Michael Underwood has sole voting and investment power with respect to the shares of common stock of VirnetX Holding Corporation held by Underwood Family Partners;
- the voting and investment power with respect to the shares of common stock of VirnetX Holding Corporation held by The Elevation Fund, LLC are shared by the following individual partners: Lance J. Baller, Dr. Paul Dragul, Paulette Dragul, Stephen D. Garland, Arthur Kassoff, Charles F. Kirby, Cynthia Kirby, John P. McGrain, Barbara Ann Bobbi Norris, Jeffrey P. Ploen, Patrick Reidy, LA Walker and Linda Walker;
- the voting and investment power with respect to the shares of common stock of VirnetX Holding Corporation held by The West Hampton Special Situations Fund, LLC are shared by the following individual partners: Amy Atkinson, Lance J. Baller, Lisa Bingaman Kirby, Robert Burg, Stephen Case, Dr. Paul Dragul, Paulette Dragul, Stephen D. Garland, Arthur Kassoff, Gary Keogh, Charles Kirby, Cynthia Kirby, Heather Evans, Deborah Lombardi, Thomas Manoogian, Gary McAdam, Douglas Moreland, Barbara Ann Bobbi Norris, Clarence Osborn, John Paulson, John Paulson Jr., Jeff Ploen, Patrick Reidy, Daniel Rudden; Gerald Rudden, Meredith Rudden, L. Michael Underwood, Frank Visciano, Lorraine Visciano, LA Walker, Linda Walker, Justin Yorke, Robin Young and Stewart Young;
- the voting and investment power with respect to the shares of common stock of VirnetX Holding Corporation held by The Kirby Enterprise Fund, LLC are shared by the following individual partners: Robert Burg, David Culberson, William Gordica, Arthur Kassoff, Gary Keogh, Charles Kirby, Earnest Mathis, Gary McAdam, John P. McGrain, W. Douglas Moreland, Barbara Ann Bobbi Norris, Clarence Osborn, Jeff Ploen, Gail Ploen, Frank Visciano, Lorraine Visciano, LA Walker, Linda Walker, Jim Waters and Cora Waters; and
- Charles Kirby III has sole voting and investment power with respect to the shares of common stock of VirnetX Holding Corporation held by Kearney Properties, LLC and Kearny Holdings, LLC.

#### **PLAN OF DISTRIBUTION**

No underwriting arrangements exist as of the date of this prospectus for the selling security holders to sell their securities. Upon being advised of any underwriting arrangements that may be entered into by a selling security holder after the date of this prospectus, VirnetX Holding Corporation will prepare a supplement to this prospectus to disclose those arrangements. We anticipate that the selling price for the common stock and warrants will be at or between the "bid" and "asked" prices for these securities, as quoted in the over-the-counter market immediately preceding the sale.

To the extent that the selling security holders intend to sell their securities directly, through agents, dealers, or through Gilford Securities Incorporated, in the over-the-counter market or otherwise, on terms and conditions that they determine at the time of sale or that they determine in private negotiations between buyer and seller, their sales of the shares of common stock may be made in accordance with this prospectus and under the provisions of Rule 144 adopted under the Securities Act.

**PART II.**  
**INFORMATION NOT REQUIRED IN PROSPECTUS**

**Item 24.        *Indemnification of Directors and Officers.***

**Delaware General Corporation Law**

Section 145 of the Delaware General Corporation Law provides that a corporation may indemnify directors and officers as well as other employees and individuals against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by such person in connection with any threatened, pending or completed actions, suits or proceedings in which such person is made a party by reason of such person being or having been a director, officer, employee or agent to the company. The Delaware General Corporation Law provides that Section 145 is not exclusive of other rights to which those seeking indemnification may be entitled under any bylaw, agreement, vote of stockholders or disinterested directors or otherwise.

Section 102(b)(7) of the Delaware General Corporation Law permits a corporation to provide in its certificate of incorporation that a director of the corporation shall not be personally liable to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, except for liability for any breach of the director's duty of loyalty to the corporation or its stockholders, for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, for unlawful payments of dividends or unlawful stock repurchases, redemptions or other distributions or for any transaction from which the director derived an improper personal benefit.

**Certificate of Incorporation**

Our Certificate of Incorporation provides that the personal liability of the directors of the company shall be eliminated to the fullest extent permitted by the provisions of Section 102(b)(7) of the Delaware General Corporation Law, as the same may be amended and supplemented.

Our Certificate of Incorporation provides that the company shall, to the fullest extent permitted by the provisions of Section 145 of the Delaware General Corporation Law, as the same may be amended and supplemented, indemnify any and all persons whom it shall have power to indemnify under said section from and against any and all of the expenses, liabilities or other matters referred to in or covered by said section, and the indemnification provided for therein shall not be deemed exclusive of any other rights to which those indemnified may be entitled under any bylaw, agreement, vote of stockholders or disinterested directors or otherwise, both as to action in his official capacity and as to action in another capacity while holding such office, and shall continue as to a person who has ceased to be a director, officer, employee or agent and shall inure to the benefit of the heirs, executors and administrators of such a person.

**Indemnification Agreements**

We have also entered into indemnification agreements with our directors and officers. The indemnification agreements provide indemnification to our directors and officers under certain circumstances for acts or omissions which may not be covered by directors' and officers' liability insurance.

**Liability Insurance**

We have also obtained directors' and officers' liability insurance, which insures against liabilities that our directors or officers may incur in such capacities.



**Item 25. Other Expenses of Issuance and Distribution.**

The following table sets forth all expenses to be paid by us, other than underwriting discounts and commissions, in connection with this offering. All amounts shown are estimates other than the registration fee.

	<u>Amount to be Paid</u>
SEC registration fee	\$ 1,149
NASD filing fee	\$ 1,880
Printing and engraving	\$ 50,000
Legal fees and expenses	\$ 400,000
Accounting fees and expenses	\$ 40,000
Blue sky fees and expenses (including legal fees)	\$ 10,000
Transfer agent and registrar fees	\$ 10,000
Miscellaneous	\$ 86,971
Total	<u>\$ 600,000</u>

**Item 26. Recent Sales of Unregistered Securities.**

On July 5, 2007, on a post-split basis, we issued an aggregate of 29,551,398 shares of our common stock and options to purchase an aggregate of 1,743,670 shares of our common stock to the former securityholders of VirnetX in the merger in exchange for 100% of the issued and outstanding capital stock and securities of VirnetX. The offer, sale and exchange of securities to existing securityholders of VirnetX, was pursuant to the exemption from registration provided by Regulation D of the Securities Act and Section 4(2) of the Securities Act and Regulation D promulgated thereunder.

On July 5, 2007, on a post-split basis, we issued to MDB Capital Group LLC and its affiliates warrants to purchase an aggregate of 266,667 shares of our common stock at \$0.75 per share pursuant to the provisions of the MDB Capital Group Service Agreement, as amended, which obligation we assumed from VirnetX in the merger. The issuance of the warrant was made pursuant to the exemption from registration provided by Section 4(2) of the Securities Act.

On July 25, 2007, on a post-split basis, we granted to recently hired employees of VirnetX options to purchase 1,347,899 shares of our common stock at \$4.20 per share pursuant to the VirnetX 2005 Stock Plan. The issuance of the options was pursuant to the exemption from registration provided by Rule 701 under the Securities Act.

In each of the fiscal years ended December 31, 2004, 2005 and 2006, we did not issue any other securities.

**ITEM 27. EXHIBITS.**

<u>Exhibit No.</u>	<u>Description</u>
1.1	Form of Underwriting Agreement
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., VirnetX Acquisition, Inc. and VirnetX, Inc. dated as of June 12, 2007(1)
3.1	Certificate of Incorporation of the Company(1)
3.2	By-Laws of the Company(1)
4.1	Form of Warrant Issued to affiliates of MDB Capital Group LLC(1)
4.2	Form of Warrant To Be Issued to Gilford Securities Incorporated
5.1	Opinion of Orrick, Herrington & Sutcliffe LLP
10.1	Form of Registration Rights Agreement, dated as of July 5, 2007, by and among the Company and all securityholders(1)
10.2	Form of Lock-Up Agreement, dated as of July 5, 2007, by and between the Company and all securityholders(1)
10.3	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)
10.4	Patent License and Assignment Agreement by and between the Company and Science Applications International Corporation, dated as of August 12, 2005(1)
10.5	Security Agreement by and between the Company and Science Applications International Corporation, dated as of August 12, 2005(1)
10.6	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)
10.7	Assignment Agreement between the Company and Science Applications International Corporation, dated as of December 21, 2006(1)
10.8	Professional Services Agreement by and between the Company and Science Applications International Corporation, dated as of August 12, 2005(1)
10.9	Lease Agreement by and between the Company and Granite Creek Business Center, dated as of March 15, 2006, as amended on April 1, 2007(1)
10.10	Consulting Agreement by and between the Company and Magenic Technologies, Inc. dated as of February 23, 2006(1)
21.1	Subsidiaries of VirnetX Holding Corporation
23.1	Consent of Burr, Pilger & Mayer LLP, Independent Accountants
23.2	Consent of Farber Hass Hurley & McEwen, LLP, Independent Auditors
23.3	Consent of Orrick, Herrington & Sutcliffe LLP (contained in Exhibit 5.1)
24.1	Power of Attorney (contained in the signature pages hereto)

(1) Incorporated by reference to the Company's Form 8-K filed with the Securities and Exchange Commission on July 12, 2007.

**Item 28. Undertakings.**

The undersigned registrant hereby undertakes:

1. To file, during any period in which offers or sales of securities are being made, a post-effective amendment to this registration statement to (a) include any prospectus required by Section 10(a)(3) of the Securities Act; (b) reflect in the prospectus any facts or events which, individually or together, represent a fundamental change in the information in the registration statement; and, notwithstanding the foregoing, any increase or decrease in volume of securities offered (if the total dollar value of securities offered would not exceed that which was registered) and any deviation from the low or high end of the estimated maximum offering range may be reflected in the form of prospectus filed with the SEC pursuant to Rule 424(b) if, in the aggregate, the changes in the volume and price represent no more than a 20% change in the maximum

aggregate offering price set forth in the “Calculation of Registration Fee” table in the effective registration statement; and (c) include any additional or changed material information on the plan of distribution.

2. For determining liability under the Securities Act, to treat each post-effective amendment as a new registration statement of the securities offered, and the offering of the securities at that time to be the initial *bona fide* offering.

3. To file a post-effective amendment to remove from registration any of the securities that remain unsold at the end of the offering.

4. For determining liability of the undersigned registrant under the Securities Act to any purchaser in the initial distribution of the securities, the undersigned registrant undertakes that in a primary offering of securities of the undersigned registrant pursuant to this registration statement, regardless of the underwriting method used to sell the securities to the purchaser, if the securities are offered or sold to such purchaser by means of any of the following communications, the undersigned registrant will be a seller to the purchaser and will be considered to offer or sell such securities to such purchaser:

- (i) any preliminary prospectus or prospectus of the undersigned registrant relating to the offering required to be filed pursuant to Rule 424;
- (ii) any free writing prospectus relating to the offering prepared by or on behalf of the undersigned registrant or used or referred to by the undersigned registrant ;
- (iii) the portion of any other free writing prospectus relating to the offering containing material information about the undersigned registrant or its securities provided by or on behalf of the undersigned registrant; and
- (iv) any other communication that is an offer in the offering made by the undersigned registrant to the purchaser.

The undersigned registrant will provide to the underwriter at the closing specified in the underwriting agreement certificates in such denominations and registered in such names as required by the underwriter to permit prompt delivery to each purchaser.

Insofar as indemnification for liabilities arising under the Securities Act of 1933 (the “Act”) may be permitted to directors, officers and controlling persons of the undersigned registrant pursuant to the foregoing provisions, or otherwise, the undersigned registrant issuer has been advised that, in the opinion of the Securities and Exchange SEC, such indemnification is against public policy as expressed in the Act and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by the undersigned registrant of expenses incurred or paid by a director, officer or controlling person of the undersigned registrant in the successful defense of any action, suit or proceeding) is asserted by such director, officer or controlling person in connection with the securities being registered, the undersigned registrant will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the questions whether such indemnification by it is against public policy as expressed in the Act and will be governed by the final adjudication of such issue.

The undersigned registrant hereby undertakes that:

(1) For determining any liability under the Securities Act, treat the information omitted from the form of prospectus filed as part of this registration statement in reliance upon Rule 430(A) and contained in a form of prospectus filed by the undersigned registrant pursuant to Rule 424(b)(1), or (4) or 497(h) under the Securities Act as part of this registration statement as of the time the SEC declared it effective.

(2) For determining any liability under the Securities Act, treat each post-effective amendment that contains a form of prospectus as a new registration statement for the securities offered in the registration statement, and that offering of the securities at that time as the initial *bona fide* offering of those securities.

The undersigned registrant hereby further undertakes that:

For determining liability under the Securities Act to any purchaser: Each prospectus filed pursuant to Rule 424(b) as part of a registration statement relating to an offering, other than registration statements relying on Rule 430B or other than prospectuses filed in reliance on Rule 430A, shall be deemed to be part of and included in the registration statement as of the date it is first used after effectiveness. Provided however, that no statement made in a registration statement or prospectus that is part of the registration statement or made in a document incorporated or deemed incorporated by reference into the registration statement or prospectus that is part of the registration statement will, as to any purchaser with a time of contract of sale prior to such first use, supersede or modify any statement that was made in the registration statement or prospectus that was part of the registration statement or made in any such document immediately prior to such date of first use.

**SIGNATURES**

In accordance with the requirements of the Securities Act, the registrant certifies that it has reasonable grounds to believe that it meets all of the requirements of filing on Form SB-2 and authorized this registration statement to be signed on its behalf by the undersigned in the City of Scotts Valley, State of California, on November 5, 2007.

VIRNETX HOLDING CORPORATION

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

In accordance with the requirements of the Securities Act, this registration statement was signed by the following persons in the capacities and on the dates stated:

<u>Signature and Name</u>	<u>Capacity</u>	<u>Date</u>
<u>/s/ Kendall Larsen</u> Kendall Larsen	President, Chief Executive Officer (Principal Executive Officer) and Director	November 5, 2007
<u>/s/ William E. Sliney*</u> William E. Sliney	Chief Financial Officer (Principal Accounting and Financial Officer)	November 5, 2007
<u>/s/ Edmund C. Munger*</u> Edmund C. Munger	Director	November 5, 2007
<u>/s/ Scott C. Taylor*</u> Scott C. Taylor	Director	November 5, 2007
<u>/s/ Michael F. Angelo*</u> Michael F. Angelo	Director	November 5, 2007
<u>/s/ Thomas M. O'Brien*</u> Thomas M. O'Brien	Director	November 5, 2007

\* By Kendall Larsen as his attorney-in-fact

## EXHIBIT INDEX

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23.3	Consent of Orrick, Herrington & Sutcliffe LLP (contained in Exhibit 5.1)
24.1	Power of Attorney (contained in the signature pages hereto)

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(1) Incorporated by reference to the Company's Form 8-K filed with the Securities and Exchange Commission on July 12, 2007.

VirnetX Holding Corporation  
Common Stock  
UNDERWRITING AGREEMENT

Gilford Securities Incorporated  
777 Third Avenue, 17th Floor  
New York, New York 10017

New York, New York  
November \_\_, 2007

Ladies and Gentlemen:

In connection with a secondary public offering (the "Offering") of common stock, \$0.0001 par value ("Common Stock"), of VirnetX Holding Corporation, a Delaware corporation (the "Company"), the Company proposes to issue and sell to Gilford Securities Incorporated (the "Underwriter" or "you") pursuant to this Underwriting Agreement (the "Agreement") 3,000,000 shares of Common Stock (the "Primary Offering Shares"). The date on which the Securities and Exchange Commission (the "Commission") shall declare the Registration Statement (as defined below) of the Company effective under the Securities Act of 1933, as amended (the "Act"), shall be the "Effective Date." In addition, the Company proposes to grant to the Underwriter the option referred to in Section 2(b) to purchase all or any part of an aggregate of 450,000 additional shares of Common Stock (the "Over-Allotment Shares" and, together with the Primary Offering Shares, the "Shares").

The Company confirms the agreements made by it with respect to the purchases of the Shares by the Underwriter, as follows:

**1. Representations, Warranties and Agreements of the Company.** The Company represents and warrants to, and agrees with the Underwriter that as of the date hereof, the Effective Date, and each Closing Date (all as hereinafter defined) that:

(a) A registration statement (File No. 333-145765) on Form SB-2 relating to the Offering, including a form of prospectus subject to completion, copies of which have heretofore been delivered to you, has been prepared in conformity in all material respects with the requirements of the Act and the rules and regulations (the "Rules and Regulations") of the Commission promulgated thereunder, and has been filed with the Commission under the Act and one or more amendments to such registration statement may have been so filed. After the execution of this Agreement, the Company will file with the Commission either (i) if such registration statement, as it may have been amended, has been declared by the Commission to be effective under the Act, a prospectus in the form most recently included in an amendment to such registration statement (or, if no such amendment shall have been filed in such registration statement), with such changes or insertions as are required by Rule 430A under the Act or

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permitted by Rule 424(b) under the Act and as have been provided to and approved by you prior to the execution of this Agreement, or (ii) if such registration statement, as it may have been amended, has not been declared by the Commission to be effective under the Act, an amendment to such registration statement, including a form of prospectus, a copy of which amendment has been furnished to and approved by you prior to the execution of this Agreement. As used in this Agreement, the term "**Registration Statement**" means such registration statement, as amended at the time when it was or is declared effective under the Act, including all financial schedules and exhibits thereto and including any information omitted therefrom pursuant to Rule 430A under the Act and included in the Prospectus (as hereinafter defined); the term "**Preliminary Prospectus**" means each prospectus subject to completion filed with such registration statement or any amendment thereto (including the prospectus subject to completion, if any, included in the Registration Statement or any amendment thereto at the time it was or is declared effective) under the Act; and the term "**Prospectus**" means the prospectus first filed with the Commission pursuant to Rule 424(b) under the Act, or if no prospectus is required to be filed pursuant to Rule 424(b), such term means the prospectus included in the Registration Statement; except that upon filing of an amendment to the registration statement or prospectus or a supplement to the prospectus after the Effective Date and prior to any Closing Date, the term "**Registration Statement**" shall include such registration statement as so amended, and the term "**Prospectus**" shall include the prospectus as so amended or supplemented.

(b) The Commission has not issued any order preventing or suspending the use of any Preliminary Prospectus. At the time the Registration Statement becomes effective and at all times subsequent thereto up to and on each Closing Date: (i) the Registration Statement and Prospectus will in all material respects conform to the requirements of the Act and the Rules and Regulations; and (ii) neither the Registration Statement nor the Prospectus will include any untrue statement of a material fact or omit to state any material fact required to be stated therein or necessary to make statements therein not misleading (in light of the circumstances under which they were made in the case of the Prospectus); provided, however, that the Company makes no representations, warranties or agreements as to information contained in or omitted from the Registration Statement or Prospectus in reliance upon, and in conformity with, written information furnished to the Company by or on behalf of the Underwriter specifically for use in the preparation thereof. It is understood that the statements set forth in the Prospectus under the heading "**Underwriting**," and the identity of counsel to the Underwriter under the heading "**Legal Matters**" constitute, for purposes of this section, the only information furnished in writing by or on behalf of the Underwriter for inclusion in the Registration Statement and Prospectus.

(c) Each of the Company and its subsidiaries has been duly incorporated and is validly existing as a corporation in good standing, or the substantial equivalent thereof, under the laws of the jurisdiction of its incorporation with full corporate power and authority to own its properties and conduct its business as described in the Prospectus and is duly qualified or licensed to do business as a foreign corporation and is in good standing in each other jurisdiction in which the nature of its business or the character or location of its properties requires such qualification, except where the failure to so qualify will not materially adversely affect the Company's business, properties or financial condition.



(d) As of each Closing Date, the authorized, issued and outstanding securities (including, but not limited to, all shares of capital stock, options, warrants, convertible instruments, and notes and debentures of any kind) of the Company will be as set forth in the Prospectus (which provides in detail all the terms of all such securities, the owners thereof, the amount authorized and the amount outstanding) which, other than any securities issued in the Offering, shall not change prior to the last Closing Date. All of such outstanding securities have been duly authorized, validly issued, fully paid and are non-assessable, and other than as set forth in the Prospectus: (i) none of the Company's capital stock is subject to preemptive rights under Delaware law or any other similar rights or any liens or encumbrances suffered or permitted by the Company; (ii) there are no outstanding debt securities issued by the Company; (iii) there are no outstanding options, warrants, scrip, rights to subscribe to, calls or commitments of any character whatsoever relating to, or securities or rights convertible into or exchangeable for, any shares of capital stock of the Company or any of its subsidiaries, or contracts, commitments, understandings or arrangements by which the Company or any of its subsidiaries is or may become bound to issue additional shares of capital stock of the Company or any of its subsidiaries or options, warrants, scrip, rights to subscribe to, calls or commitments of any character whatsoever relating to, or securities or rights convertible into or exchangeable for, any shares of capital stock of the Company or any of its subsidiaries; (iv) there are no agreements or arrangements under which the Company or any of its subsidiaries is obligated to register the sale of any of their securities under the Securities Act; (v) there are no outstanding securities of the Company or any of its subsidiaries which contain any redemption or similar provisions, and there are no contracts, commitments, understandings or arrangements by which the Company or any of its subsidiaries is or may become bound to redeem a security of the Company or any of its subsidiaries; (vi) there are no securities or instruments containing anti-dilution or similar provisions that will be triggered by the issuance of the Shares, the Underwriter's Warrant (as hereinafter defined) or the shares of Common Stock issuable upon exercise of the Underwriter's Warrant (the "Underlying Shares"); and (vii) the Company does not have any stock appreciation rights or "phantom stock" plans or agreements or any similar plan or agreement. Except as disclosed in the Registration Statement, there have been no prior offers of sales of securities of the Company in the United States, and all prior sales of securities of the Company were either registered under applicable federal and state securities laws or exempt from such registration, and no security holder has any rescission rights with respect thereto. The capital stock and other securities of the Company conform in all material respects to all statements relating thereto contained in the Registration Statement and Prospectus.

(e) The Shares, when paid for, issued and delivered pursuant to this Agreement, and the Underlying Shares, when paid for, issued and delivered pursuant to the Warrant Agreement (as defined below), will have been duly authorized, validly issued and delivered, and will be fully paid, non-assessable and free of preemptive rights of any securityholder of the Company and entitled to the rights and preferences provided by the Company's Certificate of Incorporation and Bylaws, both as amended, which will be in form and substance filed as exhibits to the Registration Statement. None of the filing of the Registration Statement, the offering or sale of the Shares as contemplated by this Agreement, the issuance of the Underwriter's Warrant or the issuance of the Underlying Shares pursuant to the Warrant Agreement gives rise to any rights, other than those which have been waived or satisfied for or relating to the registration of any securities of the Company under the Act or the laws of any

jurisdiction of the United States of America, except as described in the Registration Statement. The terms of the Shares and the Underlying Shares conform in all material respects to the description thereof in the Registration Statement and Prospectus.

(f) This Agreement and the Warrant Agreement have been, and at each Closing Date will be, duly and validly authorized, executed and delivered by the Company, and assuming due execution by the other parties thereto, are and will constitute valid and binding obligations of the Company enforceable against the Company in accordance with their respective terms, except as enforceability may be limited by bankruptcy, insolvency or other laws affecting the rights of creditors generally and that the Company makes no representation or warranty as to the enforceability of (i) the provisions purporting to govern indemnification or contribution under the securities laws of any jurisdiction or (ii) any choice of law provisions. The Company has full power and authority to authorize, issue and sell the Shares to be sold by it hereunder on the terms and conditions set forth herein and to issue the Underwriter's Warrant and the Underlying Shares pursuant to the Underwriter's Warrant, and no consent, approval, authorization or other order of any governmental authority is required in connection with such authorization, execution and delivery or in connection with the authorization, issuance and sale of the Shares or the Underlying Shares, except as may be required and have been made under the Act, or state or federal securities laws.

(g) Except for events that would not have a material adverse effect on the condition (financial or otherwise), business prospects, net worth or properties of the Company and its subsidiaries taken as a whole (a "**Material Adverse Effect**"), neither the Company nor any subsidiary is in violation, breach or default of or under, and consummation of the transactions herein contemplated and the fulfillment of the terms of this Agreement and the Warrant Agreement will not conflict with, or result in a breach or violation of, any of the terms or provisions of, or constitute a default under, or result in the creation or imposition of any lien, charge or encumbrance upon any of the property or assets of the Company or any subsidiary pursuant to the terms of any material agreement, indenture, mortgage, deed of trust, loan agreement or other agreement or instrument to which the Company or any of its subsidiaries is a party or by which the Company or any of its subsidiaries may be bound or to which any of the property or assets of the Company or any of its subsidiaries is subject, nor will such action result in any violation of the provisions of the Certificate of Incorporation, the Bylaws, or other organizational documents, as the case may be, of the Company or any of its subsidiaries, as amended, or any statute or any order, rule or regulation applicable to the Company or any of its subsidiaries, of any court or of any regulatory authority or other governmental body having jurisdiction over the Company or any of its subsidiaries.

(h) The Company and each of its subsidiaries has good and marketable title to all properties and assets described in the Prospectus as owned by each of them, free and clear of all liens, charges, encumbrances or restrictions, except as disclosed in the financial statements set forth in the Prospectus or such as are not material in relation to their business taken as a whole; all of the material leases and subleases under which the Company and each of its subsidiaries is the lessor or sublessor of properties or assets or under which the Company or each of its subsidiaries holds properties or assets as lessee or sublessee as described in the Prospectus are in full force and effect, and, except as described in the Prospectus, neither the Company nor any of

its subsidiaries is in default in any material respect with respect to any of the terms or provisions of any of such leases or subleases, and no claim has been asserted by anyone adverse to rights of the Company and each of its subsidiaries as lessor, sublessor, lessee or sublessee under any of the leases or subleases mentioned above, or affecting or questioning the right of the Company or any of its subsidiaries to continued possession of the leased or subleased premises or assets under any such lease or sublease except as described or referred to in the Prospectus; and the Company and each of its subsidiaries owns or leases all such properties described in the Prospectus as are necessary to its operations as now conducted and, except as otherwise stated in the Prospectus, as proposed to be conducted as set forth in the Prospectus. **Schedule 1(h)** lists all entities in which the Company owns 10% or more of the outstanding securities or voting rights.

(i) Each of Farber Hass Hurley & McEwen LLP and Burr, Pilger & Mayer LLP has given its reports on certain financial statements filed with the Commission as a part of the Registration Statement, which financial statements are included in the Prospectus, and each of Farber Hass Hurley & McEwen LLP and Burr, Pilger & Mayer LLP is, with respect to the Company, an independent public accounting firm as required by the Act and the Rules and Regulations.

(j) The financial statements and schedules together with related notes set forth in the Prospectus or the Registration Statement present fairly the financial position and results of operations and changes in cash flow position of the Company on the basis stated in the Prospectus, at the respective dates and for the respective periods to which they apply. Said statements and schedules and related notes have been prepared in accordance with generally accepted accounting principles in the jurisdiction(s) identified in the Prospectus applied on a basis which is consistent during the periods involved. The Company's internal accounting controls and procedures are sufficient to cause the Company and each subsidiary to prepare financial statements that comply in all material respects with generally accepted accounting principles in the jurisdiction(s) identified in the Prospectus applied on a consistent basis during the periods involved. Since the formation of the Company, nothing has been brought to the attention of the Company's management that would result in any reportable condition relating to the Company's internal accounting procedures, weaknesses or controls.

(k) Subsequent to the respective dates as of which information is given in the Registration Statement and Prospectus and except as otherwise disclosed or contemplated therein, neither the Company nor any of its subsidiaries has: (i) incurred any liabilities or obligations, direct or contingent, not in the ordinary course of business, or entered into any transaction not in the ordinary course of business; (ii) had any change in its capital stock, or any incurrence of short-term or long-term debt; (iii) issued options, warrants or other rights to purchase its capital stock; or (iv) had an adverse change or any development involving, so far as can now be reasonably foreseen, a prospective adverse change in their condition (financial or otherwise), net worth, results of operations, business, key personnel or properties, individually or which taken together, would have a Material Adverse Effect.

(l) Except as disclosed on **Schedule 1(1)** hereto, there is not now pending or, to the knowledge of the Company, threatened, any material action, suit, proceeding, inquiry, arbitration or investigation to which the Company or any of its subsidiaries or any of their

officers or directors is a party or subject to that might result in a Material Adverse Effect, nor are there any actions, suits or proceedings related to environmental matters or related to discrimination on the basis of age, sex, religion or race; and no labor disputes involving the employees of the Company or any of its subsidiaries exist or to the knowledge of the Company, are threatened which might be expected to have a Material Adverse Effect.

(m) The Company and each of its subsidiaries has filed all necessary tax returns required to be filed as of the date hereof and have paid all taxes shown as due thereon; and there is no tax deficiency that has been, or to the knowledge of the Company, may be, asserted against the Company or any of its subsidiaries.

(n) The Company and each of its subsidiaries has sufficient licenses, permits and other governmental authorizations currently necessary for the conduct of its business or the ownership of its properties as described in the Prospectus and is in all material respects complying therewith and owns or possesses adequate rights to use all material patents, patent applications, trademarks, service marks, trade-names, trademark registrations, service mark registrations, copyrights and licenses necessary for the conduct of its business and has not received any notice of conflict with the asserted rights of others in respect thereof ("**Intellectual Property**"). To the knowledge of the Company, none of the activities or business of the Company or any of its subsidiaries are in violation of, or cause the Company or any of its subsidiaries to violate, any law, rule, regulation or order of the United States or any foreign jurisdiction, any state, county or locality, or of any agency or body of the United States or any foreign jurisdiction or of any state, county or locality, the violation of which would have a Material Adverse Effect. **Schedule 1(n)** hereto sets forth all the Intellectual Property of the Company.

(o) Neither the Company, nor any of its subsidiaries, has directly or indirectly, at any time (i) made or failed to disclose fully any contributions to any candidate for political office in violation of law or (ii) made any payment to any state, federal or foreign governmental officer or official, or other person charged with similar public or quasi-public duties, other than payments or contributions required or allowed by applicable law.

(p) The Company's and each of its subsidiary's internal accounting controls and procedures are sufficient to cause each of them to comply in all material respects with the Foreign Corrupt Practices Act of 1977, the Sarbanes-Oxley Act of 2002, and the Rules and Regulations, each as in effect as of the date hereof.

(q) On each Closing Date, all transfer or other taxes (including franchise, capital stock or other tax, other than income taxes, imposed by any jurisdiction) if any, that are required to be paid in connection with the sale and transfer of the Shares hereunder will have been fully paid or provided for by the Company and all laws imposing such taxes will have been complied with in all material respects.

(r) All contracts and other documents that are, under the Rules and Regulations, required to be described in or filed as exhibits to the Registration Statement have been so described or filed, as the case may be.

(s) Other than as set forth in the Registration Statement and Prospectus, no other firm, corporation or person has any rights to underwrite or place an offering of any of the Company's securities.

(t) Except as described in the Registration Statement and Prospectus, no holder of any securities of the Company has the right to include such securities in the Registration Statement and Prospectus.

(u) Except as set forth in or contemplated by the Registration Statement and the Prospectus, neither the Company nor any of its subsidiaries has any material contingent liabilities.

(v) The Company has no material subsidiary corporations, except as disclosed in the Registration Statement and Prospectus, nor has it any equity interest in any partnership, joint venture, association or other entity, except as disclosed in the Registration Statement and Prospectus. Except as described in the Registration Statement and Prospectus, the Company owns all of the outstanding securities of each of its subsidiaries.

(w) The Commission has not issued an order preventing or suspending the use of any Preliminary Prospectus with respect to the offer and sale of the Shares and each Preliminary Prospectus, as of its date, has conformed in all material respects with the requirements of the Act and the Rules and Regulations and did not include any untrue statement of a material fact or omit to state a material fact necessary to make the statements therein not misleading (in light of the circumstances under which they were made in the case of the Prospectus).

(x) Neither the Company, nor, to the Company's knowledge, any of its officers, directors, employees or shareholders, has taken or will take, directly or indirectly, any action designed to cause or result in, or which has constituted or which might reasonably be expected to constitute, the stabilization or manipulation of the price of any of the securities of the Company.

(y) The Registration Statement accurately discloses any and all unregistered securities sold by the Company since formation. All of such securities were sold in transactions exempt from the registration provisions of the Act and not in violation of Section 5 thereof.

(z) Other than as set forth in the Registration Statement and Prospectus, the Company has not entered into any agreement pursuant to which any person is entitled, either directly or indirectly, to compensation from the Company for services as a finder in connection with the Offering, and the Company agrees to indemnify and hold harmless the Underwriter against any losses, claims, damages or liabilities, which shall include, but not be limited to, all costs to defend against any such claim, so long as such claim arises out of agreements made or allegedly made by the Company.

(aa) Except as set forth in the Registration Statement, based upon written representations received by the Company, no officer, director or five percent or greater shareholder of the Company has any direct or indirect affiliation or association with any member of the National Association of Securities Dealers, Inc. ("**NASD**") and no beneficial owner of the Company's unregistered securities has any direct or indirect affiliation or association with any NASD member. The Company will advise the Underwriter and the NASD if, to its knowledge, any five percent or greater shareholder of the Company is or becomes an affiliate or associated person of an NASD member participating in the distribution of the Shares.

(bb) The Company and each of its subsidiaries is in compliance in all material respects with all laws and regulations respecting the employment of its employees and employment practices, terms and conditions of employment and wages and hours relating thereto. There are no pending investigations involving the Company or any of its subsidiaries by any governmental agency responsible for the enforcement of such laws and regulations. There is no unfair labor practice charge or complaint against the Company or any of its subsidiaries pending before any governmental agency or body or any strike, picketing, boycott, dispute, slowdown or stoppage pending, or to the knowledge of the Company, threatened, against or involving the Company or any of its subsidiaries or any predecessor entity. No question concerning representation exists respecting the employees of the Company or any of its subsidiaries and no collective bargaining agreement or modification thereof is currently being negotiated by the Company or any of its subsidiaries. No grievance or arbitration proceeding is pending under any expired or existing collective bargaining agreements of the Company or any of its subsidiaries, if any.

(cc) Each certificate signed by any officer of the Company and delivered to the Underwriter or counsel to the Underwriter shall be deemed to be a representation and warranty by the Company to the Underwriter as to the matters covered thereby.

(dd) None of the Company, its subsidiaries, any of their affiliates, or any person acting on any of their behalf has, directly or indirectly, made any offers or sales of any security or solicited any offers to buy any security, under circumstances that would cause the Offering to be integrated with prior offerings by the Company for purposes of the Act or any applicable shareholder approval provisions. None of the Company, its subsidiaries, their affiliates or any person acting on any of their behalf will take any action or steps referred to in the preceding sentence that would cause the Offering to be integrated with other offerings.

(ee) The Company and its Board of Directors have taken all necessary action, if any, in order to render inapplicable any control share acquisition, business combination, poison pill (including any distribution under a rights agreement) or other similar anti-takeover provision under the Company's Certificate of Incorporation, as amended, or Bylaws, as amended, stock option plan, or the laws of Delaware that is or could become applicable as a result of the transactions contemplated by this Agreement including, without limitation, the Company's issuance of the Shares, the Underwriter's Warrant and the Underlying Shares.

(ff) As of the date hereof, Kendall Larsen (the "**Key Executive**") is employed by the Company on a full-time basis, and, to the best of the Company's knowledge, is not planning to cease being employed by the Company on a full-time basis in his current capacity

and the Company is not aware of any circumstances related to the employment of the Key Executive, apart from circumstances related to the operation of the Company as a whole, that could result in cessation of his full-time employment in his current capacity.

(gg) The Company acknowledges and agrees that (i) the purchase and sale of the Shares is an arms' length commercial transaction between the Company and the Underwriter, (ii) in connection therewith, the Underwriter is acting as principal and not the agent or fiduciary of the Company, and (iii) the Underwriter has not assumed an advisory responsibility in favor of the Company with respect to the offering contemplated hereby or the process leading thereto (irrespective of whether the Underwriter has advised or is currently advising the Company on other matters) or any other obligation to the Company except the obligations expressly set forth in this Agreement.

## **2. Purchase, Delivery and Sale of the Shares**

(a) Subject to the terms and conditions of this Agreement, and upon the basis of the representations, warranties and agreements, herein contained, the Company agrees to issue and sell to the Underwriter and the Underwriter agrees to buy from the Company, an aggregate of 3,000,000 Shares at \$\_\_\_\_\_ per Share (the offering price less 7%), at the place and time herein specified. The price at which the Underwriter shall sell the Shares to the public shall be \$\_\_\_\_\_ per Share.

Delivery of the Primary Offering Shares against payment therefor shall take place at the offices of the Underwriter, 777 Third Avenue, 17<sup>th</sup> Floor, New York, New York 10017 (or at such other place as may be designated by agreement between the Underwriter and the Company) at 9:30 a.m., New York time, on such date after the Registration Statement has become effective under the Act as the Underwriter shall designate, but not later than three business days following the first date that any of the Shares are released to the Underwriter, such time and date of payment and delivery for the Primary Offering Shares being hereinafter referred to as the "**First Closing Date**."

(b) In addition, subject to the terms and conditions of this Agreement, and upon the basis of the representations, warranties and agreements herein contained, the Company hereby grants an option to the Underwriter (the "**Over-Allotment Option**") to purchase all or any part of an aggregate of an additional 450,000 Over-Allotment Shares to cover over-allotments at the same price per Share as the Underwriter shall pay for the Primary Offering Shares. This option may be exercised one or more times within 45 days after the Effective Date upon written notice by the Underwriter to the Company advising as to the amount of Over-Allotment Shares to which the option is being exercised. Delivery of the Over-Allotment Shares against payment therefor shall take place at the offices of the Underwriter as identified above (or at such other place as may be designated by agreement between the Underwriter and the Company) on such date as shall be determined by the Underwriter but shall not be earlier than four nor later than 10 full business days after each exercise of the Over-Allotment Option (but in no event more than 55 days after the Effective Date), nor in any event prior to the First Closing Date (each such closing for the purchase of Over-Allotment Shares, together with the First Closing Date, a "**Closing Date**"). The Over-Allotment Option may be exercised only to cover over-allotments in the sale by the Underwriter of the Primary Offering Shares. No Over-

Allotment Shares shall be delivered unless all Primary Offering Shares shall have been delivered to the Underwriter as provided herein.

(c) The Company will make the certificates for the Shares available to you for verification at least two full business days prior to each Closing Date. The certificates shall be in such names and denominations as you may request, at least three full business days prior to each Closing Date.

Definitive certificates in negotiable form for the Shares to be purchased by the Underwriter hereunder will be delivered by the Company to you on each Closing Date for your account against payment of the respective purchase prices by the Underwriter, by wire transfer payable to the order of the Company.

**3. Covenants of the Company.** The Company covenants and agrees with the Underwriter that:

(a) The Company will use its best efforts to cause the Registration Statement to become effective under the Act. If required, the Company will file the Prospectus and any amendment or supplement thereto with the Commission in the manner and within the time period required by Rule 424(b) under the Act. Upon notification from the Commission that the Registration Statement has become effective under the Act, the Company will so advise you and will not at any time, whether before or after the Effective Date, file any amendment to the Registration Statement or supplement the Prospectus unless you have previously been furnished with a copy and to which you or your counsel shall have reasonably objected in writing or which is not in compliance with the Act and the Rules and Regulations. At any time prior to the completion by the Underwriter of the distribution of the securities contemplated hereby (but in no event more than nine months after the date on which the Registration Statement shall have become or been declared effective under the Act), the Company will prepare and file with the Commission, promptly upon your request, any amendments or supplements to the Registration Statement or Prospectus which, in the opinion of counsel to the Company and the Underwriter, may be reasonably necessary or advisable in connection with the distribution of the Shares contemplated hereby and as mutually agreed by the Company and the Underwriter.

As soon as the Company is advised thereof, the Company will advise the Underwriter, and provide the Underwriter copies of any written advice, of the receipt of any comments of the Commission, of the effectiveness under the Act of any post-effective amendment to the Registration Statement, of the filing of any supplement to the Prospectus or any amended Prospectus, of any request made by the Commission for an amendment of the Registration Statement or for supplementing of the Prospectus or for additional information with respect thereto, of the issuance by the Commission or any state or regulatory body of any stop order or other order or threat thereof suspending the effectiveness of the Registration Statement or any order preventing or suspending the use of any Preliminary Prospectus, or of the suspension of the qualification of the Shares for offering in any jurisdiction, or of the institution of any proceedings for any of such purposes, and will use its best efforts to prevent the issuance of any such order, and, if issued, to obtain as soon as possible the lifting thereof.



The Company has caused to be delivered to the Underwriter copies of each Preliminary Prospectus, and the Company has consented and hereby consents to the use of such copies for the purposes permitted by the Act. The Company authorizes the Underwriter and dealers to use the Prospectus in connection with the sale of the Shares for such period as in the opinion of counsel to the Underwriter and the Company the use thereof is required to comply with the Act and the Rules and Regulations. In case of the occurrence, at any time within such period as a Prospectus is required under the Act to be delivered in connection with sales by the Underwriter or dealers, of any event of which the Company has knowledge and which materially affects the Company or the securities of the Company, or which in the opinion of counsel for the Company or counsel for the Underwriter should be set forth in an amendment to the Registration Statement or a supplement to the Prospectus in order to make the statements therein not then misleading, or in case it shall be necessary to amend or supplement the Prospectus to comply with law or with the Rules and Regulations, the Company will notify you promptly and forthwith prepare and furnish to you copies of such amended Prospectus or of such supplement to be attached to the Prospectus, in such quantities as you may reasonably request, in order that the Prospectus, as so amended or supplemented, will not contain any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements in the Prospectus not misleading in light of the circumstances under which they were made. The preparation and furnishing of any such amendment or supplement to the Registration Statement or amended Prospectus or supplement to be attached to the Prospectus shall be without expense to the Underwriter, except that in case the Underwriter is required, in connection with the sale of the Shares to deliver a Prospectus nine months or more after the Effective Date, the Company will, upon request of the Underwriter, amend or supplement the Registration Statement and Prospectus and furnish the Underwriter with reasonable quantities of prospectuses complying with Section 10(a)(3) of the Act at the Company's expense.

The Company will comply in all material respects with the Act, the Rules and Regulations and Securities and Exchange Act of 1934, as amended (the "Exchange Act") and the rules and regulations promulgated thereunder in connection with the offering and issuance of the Shares.

(b) The Company will furnish such information as may be required and to otherwise cooperate and use its best efforts to qualify or register the Shares for sale under the securities or "blue sky" laws of such jurisdictions as you may reasonably designate and will make such applications and furnish such information as may be required for that purpose and to comply with such laws, provided the Company shall not be required to qualify as a foreign corporation or a dealer in securities or to execute a general consent of service of process in any jurisdiction in any action other than one arising out of the offering or sale of the Shares. The Company will, from time to time, prepare and file such statements and reports as are or may be required to continue such qualification in effect for so long a period as you may reasonably request.

(c) For so long as the Company is a reporting company under either Section 12 or 15(d) of the Exchange Act, the Company, at its expense and in reasonable detail, will furnish to its shareholders an annual report (including financial statements audited by independent public accountants as required by the Act), and will furnish to the Underwriter

during the period ending three years from the Effective Date hereof, (i) as soon as practicable after the end of each fiscal year, but no earlier than the filing of such information with the Commission, a balance sheet of the Company as at the end of such fiscal year, together with statements of income, and cash flow of the Company for such fiscal year, all in reasonable detail and accompanied by a copy of the certificate or report thereon of independent accountants; (ii) as soon as practicable after the end of each of the first three fiscal quarters of each fiscal year, but no earlier than the filing of such information with the Commission, consolidated summary financial information of the Company for such quarter in reasonable detail; (iii) as soon as they are publicly available, a copy of all reports (financial or other) mailed to shareholders; (iv) as soon as they are available, a copy of all non-confidential reports and financial statements furnished to or filed with the Commission or any securities exchange or automated quotation system on which any class of securities of the Company is listed; (v) copies of each press release, news item and article with respect to the Company's affairs released by the Company; and (vi) such other information as you may from time to time reasonably request. To the extent that the information required by this Section 3(c) may be filed with the Commission via the EDGAR electronic filing system, the filing of such information via the EDGAR electronic filing system shall satisfy the Company's obligations under this Section 3(c).

(d) In the event the Company has an active subsidiary or subsidiaries, such financial statements referred to in subsection (c) above will be on a consolidated basis to the extent the accounts of the Company and its subsidiary or subsidiaries are consolidated in reports furnished to its shareholders generally.

(e) On or prior to the Effective Date, all officers and directors of the Company as of the Effective Date and all selling stockholders identified in the Registration Statement shall agree in writing (in the form annexed hereto as **Exhibit A**), not to sell, transfer or otherwise dispose of (in any manner whatsoever, including public dispositions pursuant to Rule 144 under the Act) any Common Stock or securities exercisable or convertible into Common Stock for a period of 12 months from the Effective Date, or any longer period required by any state securities commission or the Over-the-Counter Bulletin-Board (the "**OTCBB**"), without the prior written consent of the Underwriter and, if applicable, the securities commission of such states or the OTCBB; provided, however, that if the average closing price per share of the Common Stock exceeds 150% of the public offering price of the Shares to be offered for 15 consecutive trading days during the lock-up period, the Common Stock held by the San Gabriel Fund, LLC group of investors (as such investors are described in the Registration Statement) holding no more than 5,333,333 shares of Common Stock (the "**San Gabriel Investors**") shall be released from the lock-up by the Underwriter. The Company further agrees not to permit, cause, suffer or assist in any such sales, dispositions or transfers. In addition, without consent of the Underwriter, the Company shall not sell or offer for sale any of its securities for a period of 13 months following the Effective Date except pursuant to options, warrants and convertible securities issued and outstanding on the date of filing of the Registration Statement or pursuant to any employee stock option plan.

(f) On the Effective Date, the Company shall have taken the necessary action to register the Shares and the Company will make all filings required to, and will have obtained approval for the listing of the Shares on the OTCBB and, so long as the Company remains a

reporting company under the Exchange Act, it will use its best efforts to maintain such listing or a listing on the Nasdaq Capital Market (“**NCS**”), Nasdaq Global Market, American Stock Exchange or New York Stock Exchange, or any similar national exchange or quotation system, for at least five years from the Effective Date.

(g) On or prior to the Effective Date, the Company will have engaged a firm of independent certified public accountants, reasonably acceptable to the Underwriter. For the purposes of this Agreement, the certified public accounting firms of Farber Hass Hurley & McEwen LLP and Burr, Pilger & Mayer LLP shall be deemed acceptable to the Underwriter. Additionally, for a period of at least five years from the Effective Date the Company will engage a firm of independent public accountants permitted to practice before the Commission.

(h) On the Effective Date, the terms and conditions of all material transactions and proposed transactions between the Company and each of its subsidiaries, on the one hand, and any of the Company’s officers, directors, affiliates or the beneficial owners of five percent or more of any class of the Company’s equity securities (including, by way of example, but not limitation, employment agreements, loans, leases, license and service agreements), on the other hand, shall be reasonably satisfactory to the Underwriter.

(i) Until the Offering has been terminated or concluded, as the case may be, the Company will not issue a press release or engage in any publicity, other than promotion by the Company of its products and services and other press releases in the ordinary course of its business, without the Underwriter’s prior written consent, which consent shall not be unreasonably withheld or delayed.

(j) For a period of three years from the Effective Date, the Underwriter may appoint an observer reasonably acceptable to the Company’s Board of Directors who will be able to attend all meetings of the Board of Directors and who need not be the same person from meeting to meeting. The Underwriter shall also have the right to written notice of, and agendas with respect thereto, no later than notice to other directors of each meeting and to obtain copies of the minutes, if requested, from all Board of Directors meetings for three years following the Effective Date, whether or not an observer attends or participates in any such Board meeting. The Company agrees to reimburse the Underwriter immediately upon the Underwriter’s request therefor for any reasonable and documented food, travel and lodging expenses directly incurred by the Underwriter in connection with its designee or observer attending Company Board of Directors meetings. Nothing in this Section 3(j) shall require the Company or its Board of Directors to waive its attorney-client privilege with respect to deliberations and meetings and materials with respect thereto.

(k) The Company shall direct the Depository Trust Company, or such other depository of the Company’s securities, to deliver a “special security position report” to the Underwriter on a daily basis for the first 30 days after the Effective Date and on a weekly basis for the first six months after the Effective Date, each at the Company’s sole expense.

(l) For a period of five years following the Effective Date, the Company will maintain registration with the Commission pursuant to Sections 12(b) or 12(g) of the Exchange

Act. In the event the Company fails to maintain registration with the Commission pursuant to Sections 12(b) or 12(g) during such five year period, the Company will provide reasonable access an independent accountant designated by the Underwriter, to all books, records and other documents or statements that reflect the Company's financial status at least once each quarter, at the Company's reasonable expense.

(m) For a period of one year from the Effective Date, so long as the Company is a reporting company under either Sections 12 or 15(d) of the Exchange Act, the Company shall: (i) retain a transfer agent reasonably acceptable to the Underwriter for the securities of the Company; and (ii) direct such transfer agent to furnish, at the Company's sole expense, the Underwriter with weekly transfer sheets as to each of the Company's securities as prepared by the Company's transfer agent and copies of lists of shareholders when requested by the Underwriter.

(n) The Company will deliver to the Underwriter two manually executed copies of the Registration Statement including all financial statements and exhibits filed therewith, and of all amendments thereto when filed with the Commission, and will deliver to the Underwriter such number of conformed copies of the Registration Statement, including such financial statements and of all amendments thereto, as the Underwriter may reasonably request. The Company will deliver to or upon the Underwriter's order, from time to time until the Effective Date, as many copies of any Preliminary Prospectus filed with the Commission prior to the Effective Date as the Underwriter may reasonably request. The Company will deliver to the Underwriter on the Effective Date and thereafter for so long as a Prospectus is required to be delivered under the Act, from time to time, as many copies of the Prospectus, in final form, or as thereafter amended or supplemented, as the Underwriter may from time to time reasonably request.

(o) If at any time during the three year period following the Effective Date, the Company's securities are no longer listed for trading on the OTCBB, another national securities exchange or NCS, the Company shall, at its own expense, undertake to list the Company's securities in the appropriate recognized securities manual or manuals published by Standard & Poor's Corporation and such other manuals as the Underwriter may designate, such listings to contain the information required by such manuals and the Uniform Securities Act (the "Manuals") and maintain such listing during said three year period, the Company shall take such action as may be reasonably requested by the Underwriter to obtain a secondary market trading exemption in such states as may be reasonably requested by the Underwriter.

(p) At the First Closing Date, the Company shall execute and deliver to you the Underwriter's Warrant Agreement (the "Warrant Agreement") substantially in the form filed as an Exhibit to the Registration Statement, representing the right to purchase such number of Shares as shall equal 10% of the Primary Offering Shares (the "Underwriter's Warrant"). The purchase price for the Underwriter's Warrant shall be \$.0001 per Underwriter's Warrant and they shall be exercisable at 120% of the offering price of the Shares at any time during the four-year period commencing on the first anniversary of the First Closing Date.

(q) As promptly as practicable after the last Closing Date, the Company will prepare, at its own expense, hard cover "bound volumes" relating to the offering, and will distribute such volumes to the individuals designated by the Underwriter or counsel to the Underwriter.

(r) The Company will apply the net proceeds from the sale of the Shares substantially for the purposes set forth under "Use of Proceeds" in the Prospectus.

(s) The Company will make generally available to its securityholders and deliver to the Underwriter as soon as it is practicable to do so but in no event later than 90 days after the end of 12 months after its current fiscal quarter, an earnings statement (which need not be audited) covering a period of at least 12 consecutive months beginning after the Effective Date, which shall satisfy the requirements of Section 11(a) of the Act.

(t) The Company will reserve and keep available the maximum number of unissued Underlying Shares and Over-Allotment Shares.

(u) For such period as the Company's securities are registered under the Exchange Act, the Company will use reasonable best efforts to hold an annual meeting of shareholders for the election of directors within 180 days after the end of each of the Company's fiscal years and, will provide the Company's shareholders with the audited financial statements and annual reports as required by the Exchange Act and the rules and regulations thereunder.

(v) The Company represents that it has not taken and agrees that it will not take, directly or indirectly, any action designed to or which has constituted or which might reasonably be expected to cause or result in the stabilization or manipulation of the price of any of the Shares.

**4. Conditions of Underwriter's Obligation.** The obligations of the Underwriter to purchase and pay for the Shares are subject to the accuracy as of the date hereof, and as of each Closing Date to the continuing accuracy of and compliance with the representations and warranties of the Company herein, to the performance by the Company of its obligations hereunder, and to the following conditions:

(a) (i) The Registration Statement shall have become and remain effective under the Act and the Underwriter shall have received notice thereof not later than 10:00 a.m. New York time, on the day following the date of this Agreement, or at such later time and on such date as to which Underwriter may agree in writing; (ii) on or prior to each Closing Date no stop order suspending the effectiveness of the Registration Statement under the Act or any applicable state securities law shall have been issued and no proceedings for that or a similar purpose shall have been instituted or shall be pending or, to the knowledge of the Company, shall be threatened or contemplated by the Commission or any state securities commission; (iii) to the knowledge of the Company, no stop order suspending the effectiveness of the qualification or registration of the Shares under the securities or "blue sky" laws of any jurisdiction (whether or not a jurisdiction which you shall have specified) shall be threatened or contemplated by the authorities of any such jurisdiction or shall have been issued and remain in effect; (iv) any

request for additional information on the part of the Commission or any such authorities shall have been complied with to the satisfaction of the Commission, such authorities and the Underwriter; and (v) after the date hereof no amendment or supplement to the Registration Statement or the Prospectus shall have been filed unless a copy thereof was first submitted to the Underwriter and the Underwriter did not object thereto. If required, the Prospectus shall have been filed with the Commission in the manner and within the time period required by Rule 424(b) under the Act.

(b) You shall have received the opinion, dated as of each Closing Date, of Orrick, Herrington & Sutcliffe LLP, counsel for the Company, in form and substance satisfactory to the Underwriter, to the effect specified in **Exhibit B** attached hereto.

The foregoing opinion shall also cover such matters incident to the transactions contemplated hereby as the Underwriter shall reasonably request. In rendering such opinion, such counsel may rely upon certificates of any officer of the Company or public officials as to matters of fact.

Such counsel shall also include, or render separately, a statement to the effect that such counsel has participated in the preparation of the Registration Statement and the Prospectus and nothing has come to the attention of such counsel to lead such counsel to believe that the Registration Statement or any amendment thereto at the time it became effective under the Act and on each Closing Date contained any untrue statement of a material fact or omitted to state any material fact required to be stated therein or necessary to make the statements therein not misleading or that the Prospectus or any amendment or supplement thereto, as of its date on each Closing Date, contains any untrue statement of a material fact or omits to state a material fact required to be stated therein or necessary in order to make the statements therein not misleading in light of the circumstances under which they were made (except, in the case of both the Registration Statement and any amendment thereto and the Prospectus and any supplement thereto, for the financial statements, notes thereto and other financial information and statistical data contained therein, as to which such counsel need express no opinion).

(c) All corporate proceedings and other legal matters relating directly or indirectly to this Agreement, the Registration Statement, the Prospectus and other related matters shall be reasonably satisfactory to the Underwriter.

(d) You shall have received a letter prior to the Effective Date and again on and as of each Closing Date from each of Farber Hass Hurley & McEwen LLP and Burr, Pilger & Mayer LLP, independent public accountants for the Company, substantially in the form and substance satisfactory to the Underwriter, stating that:

(i) they are independent public accountants with respect to the Company within the meaning of the Act and the applicable rules and regulations;

(ii) the financial statements and the schedules included in the Registration Statement and the Prospectus were examined by them and, in their opinion, comply as to form in all material respect with the applicable accounting

requirements of the Act, the Rules and Regulations and instructions of the Commission with respect to Registration Statements on Form SB-2;

(iii) on the basis of inquiries and procedures conducted by them (not constituting an examination in accordance with generally accepted auditing standards), including a reading of the latest available unaudited interim financial statements or other financial information of the Company (with an indication of the date of the latest available unaudited interim financial statements), inquiries of officers of the Company who have responsibility for financial and accounting matters, review of minutes of all meetings of the shareholders and the Board of Directors of the Company and other specified inquiries and procedures, nothing has come to their attention as a result of the foregoing inquiries and procedures that causes them to believe that:

(A) during the period from (and including) the date of the financial statements in the Registration Statement and the Prospectus to a specified date not more than five days prior to the date of such letters, there has not been any change in the capital stock, long-term debt or other securities of the Company (except as specifically contemplated in the Registration Statement and Prospectus) or any material decreases in net current assets, net assets, shareholder's equity, working capital or in any other item appearing in the Company's financial statements as to which the Underwriter may request advice, in each case as compared with amounts shown in the balance sheet as of the date of the financial statement in the Prospectus, except in each case for changes, increases or decreases that the Prospectus discloses have occurred or will occur;

(B) during the period from (and including) the date of the financial statements in the Registration Statement and the Prospectus to such specified date there was any material decrease in revenues or in the total or per share amounts of income or loss before extraordinary items or net income or loss, or any other material change in such other items appearing in the Company's financial statements as to which the Underwriter may request advice, in each case as compared with the fiscal period ended as of the date of the financial statement in the Prospectus, except in each case for increases, changes or decreases that the Prospectus discloses have occurred or will occur;

(C) the unaudited interim financial statements of the Company appearing in the Registration Statement and the Prospectus (if any) comply as to form in all material respects with the applicable accounting requirements of the Act and the Rules and Regulations and are fairly presented in conformity with generally accepted accounting principles and practices on a basis substantially consistent with the audited financial statements included in the Registration Statements or the Prospectus; and

(iv) they have compared specific dollar amounts, numbers of shares, percentages of revenues and earnings, statements and other financial information

pertaining to the Company set forth in the Prospectus in each case to the extent that such amounts, numbers, percentages, statements and information may be derived from the general accounting records, including work sheets, of the Company and excluding any questions requiring an interpretation by legal counsel, with the results obtained from the application of specified readings, inquiries and other appropriate procedures (which procedures do not constitute an examination in accordance with generally accepted auditing standards) set forth in the letters and found them to be in agreement.

Such letters shall also set forth such other information as may be reasonably requested by counsel for the Underwriter. Any changes, increases or decreases in the items set forth in such letters which, in the judgment of the Underwriter, are materially adverse with respect to the financial position or results of operations of the Company shall be deemed to constitute a failure of the Company to comply with the conditions of the obligations to the Underwriter hereunder.

(e) You shall have received an opinion from Brownstein Hyatt Farber Schreck, P.C., your counsel, to the effect specified in **Exhibit C** attached hereto.

(f) (i) the representations and warranties of the Company contained in this Agreement shall be true and correct in all material respects with the same effect as if made on and as of the Closing Dates, taking into account the Over-Allotment Option Closing Date(s) and the effect of the transactions contemplated hereby, and the Company shall have performed all of its obligations hereunder and satisfied all of the conditions on its part to be satisfied at or prior to such Closing Date; (ii) the Registration Statement and the Prospectus and any amendments or supplements thereto shall contain all statements which are required to be stated therein in accordance with the Act and the Rules and Regulations, and shall in all material respects conform to the requirements thereof, and neither the Registration Statement nor the Prospectus nor any amendment or supplement thereto shall contain any untrue statement of a material fact or omit to state any material fact required to be stated therein or necessary to make the statements therein not misleading (in light of the circumstances under which they were made in the case of the Prospectus); (iii) there shall have been, since the respective dates as of which information is given, no material adverse change, or to the Company's knowledge, any development involving a prospective material adverse change, in the business, properties, condition (financial or otherwise), results of operations, capital stock, long-term or short-term debt or general affairs of the Company from that set forth in the Registration Statement and the Prospectus, except changes which the Registration Statement and Prospectus indicate might occur after the Effective Date and the Company shall not have incurred any material liabilities or entered into any material agreement not in the ordinary course of business other than as referred to in the Registration Statement and Prospectus; (iv) except as set forth in the Prospectus, no action, suit or proceeding at law or in equity shall be pending or, to the knowledge of the Company, threatened against the Company which would be required to be set forth in the Registration Statement, and no proceedings shall be pending or, to the knowledge of the Company, threatened against the Company before or by any commission, board or administrative agency, wherein an unfavorable decision, ruling or finding would materially and adversely affect the business, property, condition (financial or otherwise), results of operations or general affairs of the Company; and (v) you shall have received, at such Closing Date, a certificate signed by each of



the chief executive officer and the principal financial officer of the Company, dated as of such Closing Date, evidencing compliance with the provisions of this subsection (f).

(g) No action shall have been taken by the Commission or the NASD, the effect of which would make it improper, at any time prior to a Closing Date, for members of the NASD to execute transactions in the Shares and no proceedings for the taking of such action shall have been instituted or shall be pending, or, to the knowledge of the Underwriter or the Company, shall be contemplated by the Commission or the NASD. The Company and the Underwriter represent that at the date hereof each has no knowledge that any such action is in fact contemplated against it by the Commission or the NASD. The Company shall advise the Underwriter of any NASD affiliation of any of its officers, directors, or shareholders or their affiliates.

(h) Prior to the Effective Date, the Underwriter shall have received clearance from the NASD as to the amount of compensation allowable or payable to the Underwriter, as described in the Registration Statement.

(i) If any of the conditions herein provided for in this section shall not have been fulfilled in all material respects as of the date indicated, this Agreement and all obligations of the Underwriter under this Agreement may be canceled at, or at any time prior to, each Closing Date by the Underwriter notifying the Company of such cancellation in writing at or prior to the applicable Closing Date. Any such cancellation shall be without liability of the Underwriter to the Company.

(j) The Underwriter shall have received such other documents and items as it or its counsel has reasonably requested and are satisfied with all other items relating directly and/or indirectly to the Company and the Offering.

**5. Conditions of the Obligations of the Company.** The obligation of the Company to sell and deliver the Shares is subject to the condition that on or prior to each Closing Date, no stop order suspending the effectiveness of the Registration Statement under the Act and any applicable state securities law shall have been issued and no proceedings for that or a similar purpose shall have been instituted or shall be pending or, to the knowledge of the Company, threatened or contemplated by the Commission or any state securities commission. Further, the obligation of the Company to sell and deliver the Shares is subject to the accuracy of the representations of the Underwriter contained in Section 12.

**6. Indemnification.**

(a) The Company agrees (i) to indemnify and hold harmless the Underwriter and each person, if any, who controls the Underwriter within the meaning of Section 15 of the Act or Section 20(a) of the Exchange Act against any losses, claims, damages or liabilities, joint or several (which shall, for all purposes of this Agreement, include, but not be limited to, all reasonable costs of defense and investigation and all reasonable attorneys' fees), to which the Underwriter or such controlling person may become subject, under the Act or otherwise, and (ii) to reimburse, as incurred, each such Underwriter and each such controlling persons for any

legal or other expenses reasonably incurred in connection with investigating, defending against or appearing as a third party witness in connection with any losses, claims, damages or liabilities; insofar as such losses, claims, damages or liabilities (or actions in respect thereof) relating to (i) and (ii) arise out of or are based upon any untrue statement or alleged untrue statement of any material fact contained in (A) the Registration Statement, any Preliminary Prospectus, the Prospectus, or any amendment or supplement thereto, (B) any blue sky application or other document executed by the Company specifically for that purpose containing written information specifically furnished by the Company and filed in any state or other jurisdiction in order to qualify any or all of the Shares under the securities laws thereof (any such application, document or information being hereinafter called a "**Blue Sky Application**"), or arise out of or are based upon the omission or alleged omission to state in the Registration Statement, any Preliminary Prospectus, Prospectus, or any amendment or supplement thereto, or in any Blue Sky Application, a material fact required to be stated therein or necessary to make the statements therein not misleading (in light of the circumstances under which they were made in the case of the Prospectus); provided, however, that the Company will not be required to indemnify the Underwriter and any controlling persons or be liable in any such case to the extent, but only to the extent, that any such loss, claim, damage or liability arises out of or is based upon an untrue statement or alleged untrue statement or omission or alleged omission made in reliance upon and in conformity with written information furnished to the Company by or on behalf of the Underwriter specifically for use in the preparation of the Registration Statement or any such amendment or supplement thereof or any such Blue Sky Application or any such Preliminary Prospectus or the Prospectus or any such amendment or supplement thereto; provided, further that the indemnity with respect to any Preliminary Prospectus shall not be applicable on account of any losses, claims, damages, liabilities or litigation arising from the sale of Shares to any person if a copy of the Prospectus was not delivered to such person at or prior to the written confirmation of the sale to such person. This indemnity will be in addition to any liability which the Company may otherwise have.

(b) The Underwriter will indemnify and hold harmless the Company, each of its directors, each of its officers who have signed the Registration Statement, and each person, if any, who controls the Company within the meaning of the Act, against any losses, claims, damages or liabilities (which shall, for all purposes of this Agreement, include, but not be limited to, all costs of defense and investigation and reasonable attorneys' fees) to which the Company or any such director, officer or controlling person may become subject under the Act or otherwise, insofar as such losses, claims, damages or liabilities (or actions in respect thereof) arise out of or are based upon any untrue statement or alleged untrue statement of any material fact contained in the Registration Statement, any Preliminary Prospectus, the Prospectus, or any amendment or supplement thereto, or arise out of or are based upon the omission or the alleged omission to state therein a material fact required to be stated therein or necessary to make the statements therein not misleading (in light of the circumstances under which they were made in the case of the Prospectus), in each case to the extent, but only to the extent, that such untrue statement or alleged untrue statement or omission or alleged omission was made in the Registration Statement, any Preliminary Prospectus, the Prospectus, or any amendment or supplement thereto, or any Blue Sky Application in reliance upon and in conformity with written information actively furnished to the Company by the Underwriter specifically for use in the preparation thereof.

(c) Promptly after receipt by an indemnified party under this section of notice of the commencement of any action, such indemnified party will, if a claim in respect thereof is to be made against the indemnifying party under this section, notify in writing the indemnifying party of the commencement thereof; but the omission so to notify the indemnifying party will not relieve it from any liability which it may have to any indemnified party otherwise than under this section. In case any such action is brought against any indemnified party, and it notifies the indemnifying party of the commencement thereof, the indemnifying party will be entitled to participate in, and, to the extent that it may wish, jointly with any other indemnifying party similarly notified, to assume the defense thereof, subject to the provisions herein stated, with counsel reasonably satisfactory to such indemnified party, and after notice from the indemnifying party to such indemnified party of its election so to assume the defense thereof, the indemnifying party will not be liable to such indemnified party under this section for any legal or other expenses subsequently incurred by such indemnified party in connection with the defense thereof other than reasonable costs of investigation. The indemnified party shall have the right to employ separate counsel in any such action and to participate in the defense thereof, but the fees and expenses of such counsel shall not be at the expense of the indemnifying party if the indemnifying party has assumed the defense of the action with counsel reasonably satisfactory to the indemnified party; provided that the reasonable fees and expenses of such counsel shall be at the expense of the indemnifying party if (i) the employment of such counsel has been specifically authorized in writing by the indemnifying party or (ii) the named parties to any such action (including any impleaded parties) include both the indemnified party and the indemnifying party and in the reasonable judgment of the counsel to the indemnified party, it is advisable for the indemnified party to be represented by separate counsel (in which case the indemnifying party shall not have the right to assume the defense of such action on behalf of such indemnified party, it being understood, however, that the indemnifying party shall not, in connection with any one such action or separate but substantially similar or related actions in the same jurisdiction arising out of the same general allegations or circumstances, be liable for the reasonable fees and expenses of more than one separate firm of attorneys for the indemnified party, which firm shall be designated in writing by the indemnified party (other than local counsel)). No settlement of any action against an indemnified party shall be made without the consent of the indemnified party, which shall not be unreasonably withheld. The indemnified party shall not settle any action without the consent of the indemnifying party, which consent shall not be unreasonably withheld. If it is ultimately determined that indemnification is not permitted, then an indemnified party will return all monies advanced to the indemnifying party.

**7. Contribution.** In circumstances in which the indemnity agreement provided for in Section 6 is unavailable or insufficient to hold harmless an indemnified party in respect of any losses, claims, damages or liabilities (or actions in respect thereof), each indemnifying party, in order to provide for just and equitable contribution, shall contribute to the amount paid or payable by such indemnified party as a result of such losses, claims, damages or liabilities (or actions in respect thereof) in such proportion as is appropriate to reflect (i) the relative benefits received by the indemnifying party or parties on the one hand and the indemnified party on the other from the offering of the Shares or (ii) if the allocation provided by the foregoing clause (i) is not permitted by applicable law, not only such relative benefits but also the relative fault of the indemnifying party or parties on the one hand and the indemnified party on the other in

connection with the statements or omissions or alleged statements or omissions that resulted in such losses, claims, damages or liabilities (or actions in respect thereof). The relative benefit received by the Company on the one hand and the Underwriter on the other shall be deemed to be in the same proportion as the total proceeds from the offering (before deducting expenses) received by the Company to the total underwriting discounts and commissions received by the Underwriter. The relative fault of the parties shall be determined by reference to, among other things, whether the untrue or alleged untrue statement of a material fact or the omission or alleged omission to state a material fact relates to information supplied by the Company or the Underwriter, the parties' relative intents, knowledge, access to information and opportunity to correct or prevent such statement or omission, and any other equitable considerations appropriate in the circumstances. The Company and the Underwriter agree that it would not be equitable if the amount of such contributions were determined by pro rata or per capita allocation or by any other method of allocation that does not take into account the equitable considerations referred to in the first sentence of this Section 7. Notwithstanding any other provision of this Section 7, the Underwriter shall not be obligated to make contributions hereunder that in the aggregate exceed the total compensation received by the Underwriter under this Agreement, less the aggregate amount of any damages that such Underwriter has otherwise been required to pay in respect of the same or any substantially similar claim, and no person guilty of fraudulent misrepresentation (within the meaning of Section 11(f) of the Act) shall be entitled to contribution from any person who was not guilty of such fraudulent misrepresentation. For purposes of this Section 7, each person, if any, who controls the Underwriter within the meaning of Section 15 of the Act or Section 20 of the Exchange Act shall have the same rights to contribution as the Underwriter, and each director of the Company, each officer of the Company who signed the Registration Statement and each person, if any, who controls the Company within the meaning of Section 15 of the Act or Section 20 of the Exchange Act, shall have the same rights to contribution as the Company.

#### **8. Costs and Expenses.**

(a) Whether or not this Agreement becomes effective or the sale of the Shares is consummated, the Company will pay all costs and expenses incident to the performance of this Agreement by the Company including, but not limited to: (i) the fees and expenses of counsel to the Company and of the Company's accountants; (ii) the costs and expenses incident to the preparation, printing, filing and mailings or other distribution under the Act of the Registration Statement (including the financial statements therein and all amendments and exhibits thereto), Preliminary Prospectus and the Prospectus, as amended or supplemented (by post-effective amendment or otherwise); (iii) the fees of the NASD in connection with the filing required by the NASD relating to the offering of the Shares contemplated hereby; (iv) all expenses, including reasonable fees and disbursements of counsel to the Underwriter, in connection with the qualification of the Shares under the state securities or blue sky laws which the Underwriter shall designate; (v) the costs of printing and furnishing to the Underwriter copies of the Registration Statement, each Preliminary Prospectus, the Prospectus, this Agreement, and a Blue Sky Memorandum (all in such quantities as the Underwriter may reasonably request); (vi) any fees relating to the listing of the Shares on any securities exchange or trading media the Underwriter may request; (vii) the fees of the transfer agent and the costs of printing the certificates representing the Shares; (viii) the fees for sets of bound volumes and prospectus lucite "cubes"

or other memorabilia, (all in such quantities as the Underwriter may reasonably request); and (ix) the costs and expenses of the Underwriter and Underwriter's counsel, travel, due diligence and "road show" expenses in an amount not to exceed \$50,000 in the aggregate. The Company will not reimburse the Underwriter for any expenses individually in excess of \$2,000 which have not been pre-approved by the Company. The Company shall pay any and all taxes (including any transfer, franchise, capital stock or other tax imposed by any jurisdiction) on sales hereunder. The Company will also pay all costs and expenses incident to the furnishing of any amended Prospectus or of any supplement to be attached to the Prospectus as called for in Section 3(a) of this Agreement, except as otherwise set forth in said section.

(b) In addition to the foregoing expenses, on the First Closing Date, the Company shall pay to the Underwriter a non-accountable expense allowance equal to 3% of the gross proceeds received by the Company from the sale of the Primary Offering Shares (the non-accountable expense allowance shall not apply to the Over-Allotment Shares) of which an advance of \$50,000 has been paid to date by the Company; \$25,000 upon the execution of the letter of intent and \$25,000 upon the initial filing of the Registration Statement. In the event the transactions contemplated hereby are not consummated by reason of the Company being unable to perform its obligations hereunder in all material respects, the Company shall be liable for the actual accountable out-of-pocket expenses of the Underwriter, including reasonable legal fees; provided, however, that the Company shall not be required to reimburse the Underwriter for any expenses individually in excess of \$2,000 which have not been pre-approved by the Company.

(c) Except as set forth in the Prospectus and Registration Statement, no person is entitled either directly or indirectly to compensation from the Company, from the Underwriter or from any other person for services as a finder in connection with the Offering, and the Company agrees to indemnify and hold harmless the Underwriter against any losses, claims, damages or liabilities (which shall, for all purposes of this Agreement, include, but not be limited to, all costs of defense and investigation and all reasonable attorneys' fees), to which the Underwriter may become subject insofar as such losses, claims, damages or liabilities (or actions in respect thereof) arise out of or are based upon the claim of any person (other than an employee of the party claiming indemnity) or entity that he or it is entitled to a finder's fee in connection with the Offering by reason of such person's or entity's influence or prior contact with the indemnifying party.

**9. Effective Date.** The Agreement shall become effective upon its execution, except that the Underwriter may, at the Underwriter's option, delay its effectiveness until 11:00 a.m. New York time on the first full business day following the Effective Date, or at such earlier time on such business day after the Effective Date as the Underwriter in its discretion shall first commence the offering of the Shares. The time of the Offering shall mean the time when the Shares are first generally offered by you to dealers by letter or telegram. This Agreement may be terminated by you at any time before it becomes effective as provided above, except that Sections 3, 6, 7, 8, 13, 14, 15, 16 and 17 shall remain in effect notwithstanding such termination.

#### **10. Termination**

(a) After this Agreement becomes effective, this Agreement, except for Sections 3, 6, 7, 8, 12, 14, 15, 16 and 17 hereof, may be terminated at any time prior to the First Closing Date, any additional Closing Date, and the Over-Allotment Option referred to in Section 2(b) hereof, if exercised, may be cancelled at any time prior to a Closing Date, by the Underwriter if in the Underwriter's judgment it is impracticable to offer for sale or to enforce contracts made for the sale of the Shares agreed to be purchased hereunder by reason of: (i) the Company having sustained a material adverse loss, whether or not insured, by reason of fire, earthquake, flood, accident or other calamity, or from any labor dispute or court or government action, order or decree; (ii) trading in securities on the OTCBB, the New York Stock Exchange, Inc., the American Stock Exchange or the NCM having been suspended or limited; (iii) material governmental restrictions having been imposed on trading in securities generally (not in force and effect on the date hereof); (iv) a banking moratorium having been declared by United States or New York State authorities; (v) an outbreak of major international hostilities, a substantial terrorist attack, or other national or international calamity having occurred involving the United States or; (vi) the passage by the Congress of the United States or by any state legislative body of similar impact, of any act or measure, or the adoption of any orders, rules or regulations by any governmental body or any authoritative accounting institute or board, or any governmental executive, which is reasonably believed likely by the Underwriter to have a material adverse impact on the business, financial condition or financial statements of the Company or the market for the securities offered hereby; (vii) any material adverse change in the financial or securities markets beyond normal market fluctuations having occurred since the date of this Agreement; (viii) any material adverse change having occurred, since the respective dates as of which information is given in the Registration Statement and Prospectus, in the earnings, business prospects or general condition of the Company, financial or otherwise, whether or not arising in the ordinary course of business; (ix) a pending or threatened legal or governmental proceeding or action relating generally to the Company's business, or a notification having been received by the Company of the threat of any such proceeding or action, which could, in the reasonable judgment of the Underwriter, materially adversely affect the Company; (x) the Company is merged or consolidated into or acquired by another company or group or there exists a binding legal commitment for the foregoing or any other material change of ownership or control occurs; or (xi) the Company shall not have timely complied in all material respects with any material term, condition or provision on their part to be performed, complied with or fulfilled (including but not limited to those set forth in this Agreement) in connection with the Offering.

(b) If you elect to prevent this Agreement from becoming effective or to terminate this Agreement as provided in this Section 10, the Company shall be promptly notified by you by telephone, confirmed in writing.

**11. Warrant Agreement and Warrant Controlling.** In the event of any conflict in the terms of this Agreement and the Warrant Agreement or the Underwriter's Warrant, the language in the form of the Warrant Agreement and the Underwriter's Warrant shall control.

**12. Representations and Warranties of the Underwriter.** The Underwriter represents and warrants to the Company that it is registered and in good standing as a broker/dealer in all jurisdictions in which it will seek purchasers for the Shares and that it has

adequate net capital requirements to consummate the transactions contemplated by this Agreement.

**13. Representations, Warranties and Agreements to Survive Delivery.** All representations, warranties and agreements contained in this Agreement or contained in certificates of officers of the Company submitted pursuant hereto, shall be deemed to be representations, warranties and agreements at each Closing Date, and such representations, warranties and agreements of the Company and the indemnity agreements contained in Section 6 hereof shall remain operative and in full force and effect regardless of any investigation made by or on behalf of the Underwriter, the Company, any controlling person of the Underwriter or the Company, and shall survive termination of this Agreement or the issuance and delivery of the Shares and the Underwriter's Warrant.

**14. Notices.** Any communications specifically required hereunder to be in writing, if sent to the Underwriter, will be mailed, delivered or faxed and confirmed to them at Gilford Securities Incorporated, 777 Third Avenue, 17<sup>th</sup> Floor, New York, New York 10017, Attention: Robert A. Maley, facsimile number (212) 223-1683, with a copy (which shall not constitute notice) sent to Brownstein Hyatt Farber Schreck, P.C., 410 17<sup>th</sup> Street, Suite 2200, Denver, Colorado 80202, Attention: Adam J. Agron, facsimile number (303) 223-1111; if sent to the Company, will be mailed, delivered or faxed and confirmed to it at VirnetX Holding Corporation, 5615 Scotts Valley Drive, Suite 110, Scotts Valley, California 95066, Attention: Kendall Larsen, Chief Executive Officer, facsimile number [ ]; with a copy (which shall not constitute notice) sent to Orrick, Herrington & Sutcliffe LLP, 1000 Marsh Road, Menlo Park, California 94025-1015, Attention: Lowell D. Ness, facsimile number (650) 614-7401. Notice shall be deemed to have been duly given if mailed or transmitted by facsimile with receipt confirmation.

**15. Parties in Interest.** The Agreement herein set forth is made solely for the benefit of the Underwriter, the Company, any person controlling the Company or the Underwriter, and directors of the Company, nominees for directors (if any) named in the Prospectus, its officers who have signed the Registration Statement, and their respective executors, administrators, successors, assigns and no other person shall acquire or have any right under or by virtue of this Agreement. The term "**successors and assigns**" shall not include any purchaser, as such purchaser, of the Shares (exclusive of the Over-Allotment Shares).

**16. Applicable Law.** This Agreement shall be governed by and construed in accordance with the internal laws of the State of New York without regard to the conflicts of laws principles thereof. The parties hereto hereby irrevocably agree that any suit or proceeding arising directly or indirectly pursuant to or under this Agreement, shall be brought solely in a federal or state court located in the City, County and State of New York. By its execution hereof, the parties hereby covenant and irrevocably submit to the *in personam* jurisdiction of the federal and state courts located in the City, County and State of New York and agree that any process in any such action may be served upon any of them personally, or by certified mail or registered mail upon them or their agent, return receipt requested, with the same full force and effect as if personally served upon them in New York City. The parties hereto expressly and irrevocably waive any claim that any such jurisdiction is not a convenient forum for any such suit or

proceeding and any defense or lack of *in personam* jurisdiction with respect thereto. In the event of any such action or proceeding, the party prevailing therein shall be entitled to payment from the other party hereto of its reasonable counsel fees and disbursements.

**17. Counterparts.** This agreement may be executed in one or more counterparts each of which shall be deemed to constitute an original and shall become effective when one or more counterparts have been signed by each of the parties hereto and delivered to the other parties (including by fax, followed by original copies by overnight mail).

**18. Entire Agreement; Amendments.** This Agreement constitutes the entire agreement of the parties hereto and supersedes all prior written or oral agreements, understandings and negotiations with respect to the subject matter hereof. This Agreement may not be amended except in writing, signed by the Underwriter and the Company.

*[Remainder of page intentionally left blank]*



If the foregoing is in accordance with your understanding of our agreement, kindly sign and return this agreement, whereupon it will become a binding agreement between the Company and the Underwriter in accordance with its terms.

Very truly yours,

**VIRNETX HOLDING CORPORATION**

By: \_\_\_\_\_  
Name: \_\_\_\_\_  
Title: \_\_\_\_\_

The foregoing Underwriting Agreement is hereby confirmed and accepted as of the date first above written.

**GILFORD SECURITIES INCORPORATED**

By: \_\_\_\_\_  
Robert A. Maley  
President

**LIST OF SCHEDULES AND EXHIBITS**

Schedule 1(h)	-	Subsidiaries
Schedule 1(l)	-	Litigation, Etc.
Schedule 1(n)	-	Intellectual Property
Exhibit A	-	Form of Lock-up Agreement
Exhibit B	-	Form of Opinion of Orrick, Herrington & Sutcliffe LLP
Exhibit C	-	Form of Opinion of Brownstein Hyatt Farber Schreck, P.C.

## UNDERWRITER'S WARRANT AGREEMENT

Underwriter's Warrant Agreement (the "Agreement"), dated as of November \_\_, 2007, between VimetX Holding Corporation (the "Company") and Gilford Securities Incorporated (the "Underwriter").

## WITNESSETH:

WHEREAS, the Underwriter has agreed, pursuant to the underwriting agreement dated as of November \_\_, 2007 (the "Underwriting Agreement") between the Company and the Underwriter, to act as the underwriter in connection with the Company's proposed secondary public offering of up to 3,000,000 shares of the Company's common stock, \$0.0001 par value per share (the "Common Stock"), at \$\_\_\_\_\_ per share (the "Public Offering"); and

WHEREAS, the Company proposes to issue to the Underwriter and/or member firms of the National Association of Securities Dealers, Inc. ("NASD") participating in the Public Offering and the bona fide officers and partners thereof as permitted by Rule 2710(c)(7)(A) and (B) (the "Rule") of the NASD Conduct Rules (each, a "Holder," and collectively, the "Holders"), warrants ("Warrants") to purchase up to 300,000 shares of Common Stock (the "Shares"); and

WHEREAS, the Warrants to be issued pursuant to this Agreement will be issued on the Closing Date (as such term is defined in the Underwriting Agreement) by the Company to the Holders in consideration for, and as part of the compensation in connection with, the Underwriter acting as underwriter pursuant to the Underwriting Agreement.

NOW, THEREFORE, in consideration of the premises, the payment to the Company of \$.0001 per Warrant, the agreements set forth herein and other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties hereto agree as follows:

1. Grant and Period.

(a) The above recitals are true and correct. The Public Offering has been registered under a Registration Statement on Form SB-2 (File No. 333-145765) and declared effective by the Securities and Exchange Commission (the "Commission") on November \_\_, 2007 (the "Effective Date"). This Agreement, relating to the purchase of the Warrants, is entered into pursuant to the Underwriting Agreement between the Company and the Underwriter in connection with the Public Offering.

(b) Pursuant to the Warrants, the Holders are hereby granted the right to purchase from the Company, at any time during the period commencing after the one year anniversary of the effectiveness of the Offering and expiring five years after the effectiveness of the Offering (the "Expiration Time"), up to a number of shares of Common Stock of the Company equal to 10% of the number of shares sold in the Public Offering (excluding the over-allotment option) at an initial exercise price (subject to adjustment as provided in Section 7 hereof) of \$\_\_\_\_\_ per

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share (120% of the per share price of the Common Stock in the Public Offering) (the “Exercise Price” or “Purchase Price”), subject to the terms and conditions of this Agreement.

(c) Except as specifically otherwise provided herein, the Shares shall bear the same terms and conditions as such securities described under the caption “Description of Securities” in the Registration Statement, and as designated in the Company’s Amended and Restated Certificate of Incorporation and any amendments thereto, and the Holders shall have registration rights under the Securities Act of 1933, as amended (the “Act”), for the Shares, as more fully described in Section 6 of this Agreement.

2. Warrant Certificates. The warrant certificates (“Warrant Certificates”) delivered and to be delivered pursuant to this Agreement shall be in the form set forth in the form of Warrant Certificate, attached hereto and made a part hereof, with such appropriate insertions, omissions, substitutions, and other variations as required or permitted by this Agreement.

3. Exercise of Warrant.

3.1 Full Exercise.

(a) The Holder may effect a cash exercise of the Warrants by surrendering to the Company the Warrant Certificate, together with a Subscription in the form of Exhibit A attached thereto, duly executed by such Holder, at any time prior to the Expiration Time, at the Company’s principal office, accompanied by payment in cash or by certified or official bank check payable to the order of the Company in the amount of the aggregate purchase price (the “Aggregate Price”), subject to any adjustments provided for in this Agreement. The aggregate price hereunder for each Holder shall be equal to the Exercise Price multiplied by the number of Shares that are the subject of each Holder’s Warrant (as adjusted as hereinafter provided).

(b) The Holder may effect a cashless exercise of the Warrants by delivering the Warrant Certificate to the Company together with a Subscription in the form of Exhibit B attached thereto, duly executed by such Holder, in which case no payment of cash will be required. Upon such cashless exercise, the number of Shares to be purchased by each Holder shall be determined by dividing: (i) the number obtained by multiplying the number of Shares that are the subject of each Holder’s Warrant Certificate by the amount, if any, by which the then Market Value (as hereinafter defined) exceeds the Purchase Price; by (ii) the then per share Market Value. In no event shall the Company be obligated to issue any fractional securities and, at the time it causes a certificate or certificates to be issued, it shall pay the Holder in lieu of any fractional securities or shares to which such Holder would otherwise be entitled, by Company check, in an amount equal to such fraction multiplied by the Market Value. The “Market Value” shall be determined on a per Share basis as of the close of the business day preceding the date of exercise, which determination shall be made as follows: (a) if the Common Stock is listed for trading on a national or regional stock exchange or is included on the NASDAQ National Market or SmallCap Market, the average closing sale price quoted on such exchange or the NASDAQ National Market or SmallCap Market which is published in The Wall Street Journal for the 10 trading days immediately preceding the date of exercise, or if no trade of the Common Stock shall have been reported during such period, the last sale price so quoted for the next day prior thereto on which a trade in the Common Stock was so reported; or (b) if the Common Stock is

not so listed, admitted to trading or included, the average of the closing highest reported bid and lowest reported ask price as quoted on the OTC Bulletin Board or in the "Pink Sheets" published by the National Daily Quotation Bureau for the first day immediately preceding the date of exercise on which the Common Stock is traded.

3.2 Partial Exercise. The Warrants may also be exercised from time to time in part by surrendering the Warrant Certificate in the manner specified in Section 3.1 hereof, except that with respect to a cash exercise, the Purchase Price payable shall be equal to the number of Shares being purchased hereunder multiplied by the per Share Purchase Price, subject to any adjustments provided for in this Agreement. Upon any such partial exercise, the Company, at its expense, will forthwith issue to the Holder a new Warrant Certificate or Warrants of like tenor calling in the aggregate for the number of securities (as constituted as of the date hereof) for which the Warrant Certificate shall not have been exercised, issued in the name of the Holder or as such Holder (upon payment by such Holder of any applicable transfer taxes) may direct.

4. Issuance of Certificates.

(a) Upon the exercise of the Warrants, the issuance of certificates for shares of Common Stock shall be made forthwith (and, in any event within three business days thereafter) without charge to the Holder thereof including, without limitation, any tax which may be payable in respect of the issuance thereof, and such certificates shall (subject to the provisions of Section 5 and Section 6 hereof) be issued in the name of, or in such names as may be directed by, the Holder thereof; provided, however, that the Company shall not be required to pay any tax which may be payable in respect of any transfer involved in the issuance and delivery of any such certificates in a name other than that of the Holder and the Company shall not be required to issue or deliver such certificates unless or until the person or persons requesting the issuance thereof shall have paid to the Company the amount of such tax or shall have established to the satisfaction of the Company that such tax has been paid.

(b) The Warrant Certificates and the certificates representing the shares of Common Stock shall be executed on behalf of the Company by manual or facsimile signature of the then present Chairman or Vice Chairman of the Board of Directors or President or Vice President of the Company. Warrant Certificates shall be dated the date of execution by the Company upon initial issuance, division, exchange, substitution or transfer.

5. Restriction on Transfer of Warrants. The Holder of a Warrant Certificate, by acceptance thereof, covenants and agrees that the Warrants may not be sold, transferred, assigned, hypothecated or otherwise disposed of, in whole or in part, for a period of one year from the effectiveness of the Offering, except (a) to a NASD member firm that participated in the Public Offering and the bona fide officers or partners thereof, (b) by operation of law, or (c) by reason of reorganization of the Company.

6. Registration Rights.

6.1 Registration Under the Securities Act of 1933. The Warrants and the Shares (collectively the "Registrable Securities") have not been registered under the Securities Act of 1933, as amended (the "Act"). Upon exercise, in part or in whole, of the Warrants, certificates

representing the Shares shall bear the following legend in the event there is no current registration statement effective with the Commission at such time as to such securities:

The securities represented by this certificate may not be offered or sold except pursuant to (i) an effective registration statement under the Securities Act of 1933, as amended, (ii) to the extent applicable, Rule 144 under the Securities Act (or any similar rule under the Securities Act relating to the disposition of securities), or (iii) an opinion of counsel, if such opinion shall be reasonably satisfactory to counsel to the issuer, that an exemption from registration under the Securities Act and applicable state securities laws is available.

**6.2 Piggyback Registration.**

(a) If, at any time commencing on the first anniversary of the Closing Date and expiring seven years after the Closing Date, the Company prepares and files a post-effective amendment to the Registration Statement, or a new Registration Statement under the Act, or files a Notification on Form 1-A or otherwise registers securities under the Act, or files a similar disclosure document with the Commission (each such filing, a "Registration Document") as to any of its securities under the Act (other than under a Registration Statement pursuant to Form S-8 or Form S-4), it will give written notice by registered mail, at least 20 days prior to the filing of such Registration Document to the Underwriter and to all other Holders of the Registrable Securities of its intention to do so. The Company shall include all Registrable Securities in such Registration Documents with respect to which the Company has received written requests for inclusion therein within 15 days of actual receipt of the Company's notice.

(b) No Holder of Registrable Securities may participate in any registration hereunder which is underwritten unless such holder completes and executes all documents as are reasonable and customary in such offerings.

(c) The Company shall have the right at any time after it shall have given written notice pursuant to this Section 6.2 (irrespective of whether a written request for inclusion of any Registration Securities shall have been made) to elect not to file any such Registration Document, or to withdraw the same after the filing but prior to the effective date thereof.

**6.3 Demand Registration.**

(a) Expenses to be Paid by the Company. At any time commencing one year after the Closing Date until the Expiration Time, Holders of Registrable Securities representing more than 50% of such securities at that time outstanding (a "Majority of Holders") shall have the right (which right is in addition to the registration rights under Section 6.2 and Section 6.3(b) hereof), exercisable by written notice to the Company, to have the Company prepare and file with the Commission, on one occasion, a registration statement and/or such other documents, including a prospectus, and/or any other appropriate disclosure document as may be reasonably necessary in the opinion of both counsel for the Company and counsel for the Majority of Holders, in order to comply with the provisions of the Act, so as to permit a public offering and sale of their respective Registrable Securities for 12 consecutive months (or such longer period of time as permitted by the Act) by such Majority of Holders and any other Holders of any of the Registrable Securities who notify the Company within 20 days after receipt of notice by

registered or certified mail from the Company of such request ("Demand Registration"). A Demand Registration shall not be counted as a Demand Registration hereunder until such Demand Registration has been declared effective by the Commission and maintained continuously effective for a period of at least 12 months or such shorter period when all Registrable Securities included therein have been sold in accordance with such Demand Registration. The Company shall pay all costs (excluding transfer taxes, if any, and the Holders' pro-rata portions of the selling discount or commissions), fees and expenses in connection with all registration statements filed pursuant to Section 6.2 and this Section 6.3(a) including, without limitation, the Company's legal and accounting fees, printing expenses, blue sky fees and expenses and the fees and expenses of one legal counsel to the Holders, so chosen by the Holders.

(b) Expenses to be Paid by the Holder(s). At any time commencing one year after the Closing Date until the Expiration Time, a Majority of Holders shall have the right (which right is in addition to the registration rights under Sections 6.2 and Section 6.3(a) hereof), exercisable by written notice to the Company, to one Demand Registration. A Demand Registration shall not be counted as a Demand Registration hereunder until such Demand Registration has been declared effective by the Commission and maintained continuously effective for a period of at least nine months or such shorter period when all Registrable Securities included therein have been sold in accordance with such Demand Registration. The Holder(s) will pay all costs, fees and expenses in connection with any registration statement filed pursuant to Section this 6.3(b).

(c) The Company covenants and agrees to give written notice by registered or certified mail of any registration request under this Section 6.3 by the Majority of Holders to all other registered Holders of any of the Registrable Securities within 10 days from the date of the receipt of any such registration request.

(d) Any written request by the Holders made pursuant to this Section 6.3 shall:

(i) specify the number of Registrable Securities which the Holders intend to offer and sell and the minimum price at which the Holders intend to offer and sell such securities;

(ii) state the intention of the Holders to offer such securities for sale;

(iii) describe the intended method of distribution of such securities; and

(iv) contain an undertaking on the part of the Holders to provide all such information and materials concerning the Holders and take all such action as may be reasonably required to permit the Company to comply with all applicable requirements of the Commission and to obtain acceleration of the effective date of the registration statement.

6.4 Covenants of the Company with Respect to Registration. In connection with the filing of any Registration Document by the Company, the Company covenants and agrees as follows:

(a) The Company shall use its best efforts to file a registration statement within 45 days of receipt of any Demand Registration pursuant to Section 6.3, and shall use its best efforts to have any such registration statement declared effective at the earliest practicable time. The Company will promptly notify each Holder of such Registrable Securities and confirm such advice in writing, (i) when such registration statement becomes effective, (ii) when any post-effective amendment to such registration statement becomes effective and (iii) of any request by the Commission for any amendment or supplement to such registration statement or any prospectus relating thereto or for additional information.

(b) The Company shall furnish to each Holder of such Registrable Securities such number of copies of such registration statement and of each such amendment and supplement thereto (in each case including each preliminary prospectus and summary prospectus) in conformity with the requirements of the Act, and such other documents as the Holders may reasonably request in order to facilitate the disposition of the Registrable Securities by such Holders.

(c) If the Company shall fail to comply with the provisions of Section 6.3(a), the Company shall, in addition to any other equitable or other relief available to the Holder(s), be liable for any or all special and consequential damages sustained by the Holder(s) requesting registration of their Registrable Securities.

(d) The Company shall prepare and file with the Commission such amendments and supplements to such registration statement and the prospectus used in connection therewith as may be reasonably necessary to keep such registration statement effective for at least 12 months (or such longer period as permitted by the Act), and to comply with the provisions of the Act with respect to the disposition of all securities covered by such registration statement during such period in accordance with the intended methods of disposition by the Holder or Holders of Registrable Securities set forth in such registration statement. If at any time the Commission should institute or threaten to institute any proceedings for the purpose of issuing a stop order suspending the effectiveness of any such registration statement, the Company will promptly notify each Holder of Registrable Securities and will use all reasonable efforts to prevent the issuance of any such stop order or to obtain the withdrawal thereof as soon as possible. The Company will use its good faith reasonable efforts and take all reasonably necessary action which may be required in qualifying or registering the Registrable Securities included in a registration statement for offering and sale under the securities or blue sky laws of such states as reasonably are required by the Holder(s), provided that the Company shall not be obligated to execute or file any general consent to service of process or to qualify as a foreign corporation to do business under the laws of any such jurisdiction. The Company shall use its good faith reasonable efforts to cause such Registrable Securities covered by such registration statement to be registered with or approved by such other governmental agencies or authorities of the United States or any State thereof as may be reasonably necessary to enable the Holder(s) thereof to consummate the disposition of such Registrable Securities.

(e) The Company shall indemnify the Holder(s) of the Registrable Securities to be sold pursuant to any registration statement and each person, if any, who controls such Holders within the meaning of Section 15 of the Act or Section 20(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), against all loss, claim, damage, expense or



liability (including all expenses reasonably incurred in investigating, preparing or defending against any claim whatsoever) to which any of them may become subject under the Act, the Exchange Act or otherwise, arising from such registration statement but only to the same extent and with the same effect as the provisions pursuant to which the Company has agreed to indemnify the Underwriter as contained in the Underwriting Agreement.

(f) If requested by the Company prior to the filing of any registration statement covering the Registrable Securities, each of the Holder(s) of the Registrable Securities to be sold pursuant to a registration statement, and their successors and assigns, shall severally, and not jointly, indemnify the Company, its officers and directors and each person, if any, who controls the Company within the meaning of Section 15 of the Act or Section 20(a) of the Exchange Act, against all loss, claim, damage or expense or liability (including all expenses reasonably incurred in investigating, preparing or defending against any claim whatsoever) to which they may become subject under the Act, the Exchange Act or otherwise, arising from written information furnished by such Holder, or their successors or assigns, for specific inclusion in such registration statement to the same extent and with the same effect as the provisions contained in the Underwriting Agreement pursuant to which the Underwriters have agreed to indemnify the Company, except that the maximum amount which may be recovered from each Holder pursuant to this paragraph or otherwise shall be limited to the amount of net proceeds received by the Holder from the sale of the Registrable Securities.

(g) Nothing contained in this Agreement shall be construed as requiring the Holder(s) to exercise their Warrants prior to the filing of any registration statement or the effectiveness thereof.

(h) The Company shall not permit the inclusion of any securities other than the Registrable Securities to be included in any registration statement filed pursuant to Section 6.3 hereof without the prior written consent of the Majority of Holders which consent will not be unreasonably withheld or delayed.

(i) The Company shall furnish to each Holder participating in an offering and to the managing underwriter, if any, a signed counterpart, addressed to such Holder or underwriter, of (i) an opinion of counsel to the Company, dated the effective date of such registration statement (and, if such registration includes an underwritten public offering, an opinion dated the date of the closing under the underwriting agreement), and (ii) a "Cold Comfort" letter dated the effective date of such registration statement (and, if such registration includes an underwritten public offering, a letter dated the date of the closing under the underwriting agreement) signed by the independent public accountants who have issued a report on the Company's financial statements included in such registration statement, in each case covering substantially the same matters with respect to such registration statement (and the prospectus included therein) and, in the case of such accountants' letter, with respect to events subsequent to the date of such financial statements, as are customarily covered in opinions of issuer's counsel and in accountants' letters delivered to underwriters in underwritten public offerings of securities.

(j) The Company shall deliver promptly to each Holder participating in an offering and to the managing underwriter, if any, copies of all correspondence between the

Commission and the Company, its counsel or auditors and all non-privileged memoranda relating to discussions with the Commission or its staff with respect to the registration statement and permit each Holder and underwriter to do such investigation, upon reasonable advance notice, with respect to information contained in or omitted from the registration statement as it deems reasonably necessary to comply with applicable securities laws or rules of NASD. Such investigation shall include access to books, records and properties and opportunities to discuss the business of the Company with its officers and independent auditors, all to such reasonable extent and at such reasonable times and as often as any such Holder shall reasonably request.

(k) With respect to a registration statement filed pursuant to Section 6.3, the Company, if requested, shall enter into an underwriting agreement with the managing underwriter, reasonably satisfactory to the Company, selected for such underwriting by a Majority of Holders requested to be included in such underwriting. Such agreement shall be satisfactory in form and substance to the Company, each Holder and such managing underwriter, and shall contain such representations, warranties and covenants by the Company and such other terms as are customarily contained in agreements of that type used by the managing underwriter. The Holders, if required by the underwriter to be parties to any underwriting agreement relating to an underwritten sale of their Registrable Securities, may, at their option, require that any or all the representations, warranties and covenants of the Company to or for the benefit of such underwriters shall also be made to and for the benefit of such Holders. Such Holders shall not be required to make any representations or warranties to or agreements with the Company or the underwriters except as they may relate to such Holders and their intended methods of distribution.

(l) Notwithstanding the provisions of Section 6.2 or Section 6.3 of this Agreement, the Company shall not be required to effect or cause the registration of Registrable Securities pursuant to Section 6.2 or Section 6.3 hereof if, within 30 days after its receipt of a request to register such Registrable Securities (i) counsel for the Company delivers an opinion to the Holders and to the Company's transfer agent requesting registration of such Registrable Securities, in form and substance satisfactory to counsel to such Holder(s), to the effect that the entire number of Registrable Securities proposed to be sold by such Holder(s) may otherwise be sold, in the manner proposed by such Holder(s), without registration under the Securities Act, or (ii) the Commission shall have issued a no-action position, in form and substance satisfactory to counsel for the Holder(s) requesting registration of such Registrable Securities, to the effect that the entire number of Registrable Securities proposed to be sold by such Holder(s) may be sold by it, in the manner proposed by such Holder(s), without registration under the Securities Act; provided, however, if the Company's transfer agent does not permit the sale of the Registrable Securities upon request or for any other reason such sale is delayed, the Company shall thereafter immediately notify such Holders that it will register the Registrable Securities for sale under the Act and cause such Registrable Securities to be so registered.

(m) After completion of the Public Offering, the Company shall not, directly or indirectly, enter into any merger, business combination or consolidation in which (i) the Company shall not be the surviving corporation and (ii) the shareholders of the Company are to receive, in whole or in part, capital stock or other securities of the surviving corporation, unless the surviving corporation shall, prior to such merger, business combination or consolidation, agree in writing to assume the obligations of the Company under this Agreement, and for that

purpose references hereunder to "Registrable Securities" shall be deemed to include the securities which the Holders would be entitled to receive in exchange for Registrable Securities under any such merger, business combination or consolidation, provided that to the extent such securities to be received are convertible into shares of Common Stock of the issuer thereof, then any such shares of Common Stock as are issued or issuable upon conversion of said convertible securities shall also be included within the definition of "Registrable Securities."

**7. Adjustments to Exercise Price and Number of Securities:**

**7.1 Adjustment for Dividends, Subdivisions, Combinations or Reclassifications:**

(a) In case the Company shall (i) pay a dividend or make a distribution in shares of its capital stock (whether shares of Common Stock or of capital stock of any other class), (ii) subdivide its outstanding shares of Common Stock into a greater number of shares, (iii) combine its outstanding shares of Common Stock into a smaller number of shares, or (iv) issue by reclassification of its shares of Common Stock any shares of capital stock of the Company; then, and in each such case, the per Share Exercise Price and the number of Shares in effect immediately prior to such action shall be adjusted so that the Holder of this Warrant thereafter upon the exercise hereof shall be entitled to receive the number and kind of shares of the Company which such Holder would have owned immediately following such action had this Warrant been exercised immediately prior thereto. An adjustment made pursuant to this Section 7.1 shall become effective immediately after the record date in the case of a dividend or distribution and shall become effective immediately after the effective date in the case of a subdivision, combination or reclassification. If, as a result of an adjustment made pursuant to this section, the Holder of this Warrant shall become entitled to receive shares of two or more classes of capital stock of the Company, the Board of Directors of the Company (whose determination shall be conclusive) shall determine the allocation of the adjusted Exercise Price between or among shares of such class of capital stock.

(b) Immediately upon any adjustment of the Exercise Price pursuant to this section, the Company shall send written notice thereof to the Holder of Warrant Certificates (by first class mail, postage prepaid), which notice shall state the Exercise Price resulting from such adjustment, and any increase or decrease in the number of Shares to be acquired upon exercise of the Warrants, setting forth in reasonable detail the method of calculation and the facts upon which such calculation is based.

**7.2 Adjustment for Reorganization, Merger or Consolidation:** In case of any reorganization of the Company or consolidation of the Company with, or merger of the Company with, or merger of the Company into, another corporation (other than a consolidation or merger which does not result in any reclassification or change of the outstanding Common Stock), the corporation formed by such consolidation or merger shall execute and deliver to the Holder a supplemental Warrant Agreement providing that the Holder of each Warrant then outstanding or to be outstanding shall have the right thereafter (until the expiration of such Warrant) to receive, upon exercise of such warrant, the kind and amount of shares of stock and other securities and property receivable upon such consolidation or merger, by a holder of the number of shares of Common Stock of the Company for which such warrant might have been exercised immediately prior to such reorganization, consolidation, merger, conveyance, sale or

transfer. Such supplemental Warrant Agreement shall provide for adjustments which shall be identical to the adjustments provided in this Section 7 and such registration rights and other rights as provided in this Agreement. The Company shall not effect any such consolidation, merger, or similar transaction as contemplated by this paragraph, unless prior to or simultaneously with the consummation thereof, the successor corporation (if other than the Company) resulting from such consolidation or merger or the corporation purchasing, receiving, or leasing such assets or other appropriate corporation or entity shall assume, by written instrument executed and delivered to the Holders, the obligation to deliver to the Holders, such shares of stock, securities, or assets as, in accordance with the foregoing provisions, such holders may be entitled to purchase, and to perform the other obligations of the Company under this Agreement. The above provision of this Section 7.2 shall similarly apply to successive consolidations or successively whenever any event listed above shall occur.

7.3 Dividends and Other Distributions. In the event that the Company shall at any time prior to the exercise of all of the Warrants distribute to its shareholders any assets, property, rights, evidences of indebtedness, securities (other than a distribution made as a cash dividend payable out of earnings or out of any earned surplus legally available for dividends under the laws of the jurisdictions of incorporation of the Company), whether issued by the Company or by another, the Holders of the unexercised Warrants shall thereafter be entitled, in addition to the shares of Common Stock or other securities and property receivable upon the exercise thereof, to receive, upon the exercise of such Warrants, the same property, assets, rights, evidences of indebtedness, securities or any other thing of value that they would have been entitled to receive at the time of such distribution as if the Warrants had been exercised immediately prior to such distribution. At the time of any such distribution, the Company shall make appropriate reserves to ensure the timely performance of the provisions of this subsection or an adjustment to the Exercise Price, which shall be effective as of the day following the record date for such distribution.

7.4 Adjustment in Number of Securities. Upon each adjustment of the Exercise Price pursuant to the provisions of this Section 7, the number of securities issuable upon the exercise of each Warrant shall be adjusted to the nearest full amount by multiplying a number equal to the Exercise Price in effect immediately prior to such adjustment by the number of securities issuable upon exercise of the Warrants immediately prior to such adjustment and dividing the product so obtained by the adjusted Exercise Price.

7.5 No Adjustment of Exercise Price in Certain Cases. No adjustment of the Exercise Price shall be made if the amount of said adjustment shall be less than \$.01 per Share; provided, however, that in such case any adjustment that would otherwise be required then to be made shall be carried forward and shall be made at the time of and together with the next subsequent adjustment which, together with any adjustment so carried forward, shall amount to at least \$.01 per Share.

7.6 Accountant's Certificate of Adjustment. In each case of an adjustment or readjustment of the Exercise Price or the number of any securities issuable upon exercise of the Warrants, the Company, at its expense, shall cause independent certified public accountants of recognized standing selected by the Company (who may be the independent certified public accountants then auditing the books of the Company) to compute such adjustment or

readjustment in accordance herewith and prepare a certificate showing such adjustment or readjustment, and shall mail such certificate, by first class mail, postage prepaid, to any Holder of the Warrants at the Holders' address as shown on the Company's books. The certificate shall set forth such adjustment or readjustment, showing in detail the facts upon which such adjustment or readjustment is based including, but not limited to, a statement of (i) the Exercise Price at the time in effect, and (ii) the number of additional or fewer securities and the type and amount, if any, of other property which at the time would be receivable upon exercise of the Warrants.

**8. Exchange and Replacement of Warrant Certificates.**

(a) Each Warrant Certificate is exchangeable without expense, upon the surrender thereof by the registered Holder at the principal executive office of the Company, for a new Warrant Certificate of like tenor and date representing in the aggregate the right to purchase the same number of securities in such denominations as shall be designated by the Holder thereof at the time of such surrender.

(b) Upon receipt by the Company of evidence reasonably satisfactory to it of the loss, theft, destruction or mutilation of any Warrant Certificate, and, in case of loss, theft or destruction, of indemnity or security reasonably satisfactory to it, and reimbursement to the Company of all reasonable expenses incidental thereto, and upon surrender and cancellation of the Warrants, if mutilated, the Company will make and deliver a new Warrant Certificate of like tenor, in lieu thereof.

**9. Elimination of Fractional Interest.** The Company shall not be required to issue certificates representing fractions of shares of Common Stock upon the exercise of the Warrants, nor shall it be required to issue script or pay cash in lieu of fractional interests, it being the intent of the parties that all fractional interests may be eliminated, at the Company's option, by rounding any fraction up to the nearest whole number of shares of Common Stock or other securities, properties or rights, or in lieu thereof paying cash equal to such fractional interest multiplied by the Market Value of a share of Common Stock.

**10. Reservation, Validity and Listing.** The Company covenants and agrees that during the exercise period, the Company shall at all times reserve and keep available out of its authorized shares of Common Stock, solely for the purpose of issuance upon the exercise of the Warrants, such number of shares of Common Stock or other securities, properties or rights as shall be issuable upon the exercise under this Warrant Certificate. The Company covenants and agrees that, upon exercise of the Warrants, and payment of the Exercise Price therefor, all shares of Common Stock and other securities issuable upon such exercise shall be duly authorized, validly issued, fully paid, non-assessable and not subject to the preemptive rights of any shareholder. As long as the Warrants shall be outstanding, the Company shall use its best efforts to cause all shares of Common Stock issuable upon the exercise of the Warrants to be listed and quoted (subject to official notice of issuance) on all securities exchanges and systems on which the Common Stock are then listed and/or quoted, including Nasdaq and the American Stock Exchange.

11. Notices to Warrant Holders. Nothing contained in this Agreement shall be construed as conferring upon the Holders of the Warrants the right to vote or to consent or to receive notice as a shareholder in respect of any meetings of shareholders for the election of directors or any other matter, or as having any rights whatsoever as a shareholder of the Company. If, however, at any time prior to the expiration of the Warrants and their exercise, any of the following events shall occur:

(a) the Company shall take a record of the holders of its shares of Common Stock for the purpose of entitling them to receive a dividend or distribution payable otherwise than in cash, or a cash dividend or distribution payable otherwise than out of current or retained earnings, as indicated by the accounting treatment of such dividend or distribution on the books of the Company; or

(b) the Company shall offer to all the holders of its Common Stock any additional shares of capital stock of the Company or securities convertible into or exchangeable for shares of capital stock of the Company, or any option, right or warrant to subscribe therefor; or

(c) a dissolution, liquidation or winding up of the Company (other than in connection with a consolidation or merger) or a sale of all or substantially all of its property, assets and business as an entirety shall be proposed;

then, in any one or more of said events, the Company shall give written notice of such event at least 15 days prior to the date fixed as a record date of the date of closing the transfer books for the determination of the shareholders entitled to such dividend, distribution, convertible or exchangeable securities or subscription rights, or entitled to vote on such proposed dissolution, liquidation, winding up or sale. Such notices shall specify such record date or the date of closing the transfer books, as the case may be.

12. Notices. All notices, requests, consents and other communications hereunder shall be in writing and shall be deemed to have been duly given when sent by (i) facsimile; or (ii) delivered personally or by overnight courier or mailed by registered or certified mail, return receipt requested:

(a) If to the registered Holder of any of the Registrable Securities, to the address of such Holder as shown on the books of the Company.

With a copy to:

Adam J. Agron, Esq.  
Brownstein Hyatt Farber Schreck, P.C.  
410 Seventeenth Street, Suite 2200  
Denver, CO 80202-4437  
Fax: (303) 223-1111

(b) If to the Company, to the address set forth below or to such other address as the Company may designate by notice to the Holders.

Kendall Larsen  
Chief Executive Officer  
VimmetX Holding Corporation  
5615 Scotts Valley Drive, Suite 110  
Scotts Valley, CA 95066  
Fax: (831) 438-3078

With a copy to:

Lowell D. Ness, Esq.  
Orrick, Herrington & Sutcliffe LLP  
1000 Marsh Road  
Menlo Park, CA 94025  
Fax: (650) 614-7401

13. Entire Agreement; Modification. This Agreement (and the Underwriting Agreement to the extent applicable) contains the entire understanding between the parties hereto with respect to the subject matter hereof, and the terms and provisions of this Agreement may not be modified, waived or amended except in a writing executed by the Company and a Majority of Holders. Notice of any modification, waiver or amendment shall be promptly provided to any Holder not consenting to such modification, waiver or amendment.

14. Successors. All the covenants and provisions of this Agreement shall be binding upon and inure to the benefit of the Company, the Holders and their respective successors and assigns hereunder.

15. Termination. This Agreement shall terminate at the earlier of (i) the public sale of all of the Registrable Securities, or (ii) at the close of business on [November \_\_, 2012]. Notwithstanding the foregoing, the indemnification provisions of Section 6 shall survive such termination.

16. Governing Law; Submission to Jurisdiction. This Agreement shall be governed by and construed in accordance with the internal laws of the State of New York without regard to the conflicts of laws principles thereof. The parties hereto hereby irrevocably agree that any suit or proceeding arising directly and/or indirectly pursuant to or under this Agreement, shall be brought solely in a federal or state court located in the City, County and State of New York. By its execution hereof, the parties hereby covenant and irrevocably submit to the in personam jurisdiction of the federal and state courts located in the City, County and State of New York and agree that any process in any such action may be served upon any of them personally, or by certified mail or registered mail upon them or their agent, return receipt requested, with the same full force and effect as if personally served upon them in New York City. The parties hereto waive any claim that any such jurisdiction is not a convenient forum for any such suit or proceeding and any defense or lack of in personam jurisdiction with respect thereto. In the event of any such action or proceeding, the party prevailing therein shall be entitled to payment from the other party hereto of its reasonable counsel fees and disbursements in an amount judicially determined.

17. Severability. If any provision of this Agreement shall be held to be invalid or unenforceable, such invalidity or unenforceability shall not affect any other provision of this Agreement.

18. Captions. The caption headings of the sections of this Agreement are for convenience of reference only and are not intended, nor should they be construed as, a part of this Agreement and shall be given no substantive effect.

19. Benefits of This Agreement. Nothing in this Agreement shall be construed to give to any person or corporation other than the Company and the Underwriter and any other registered Holder(s) of the Warrant Certificates or Registrable Securities any legal or equitable right, remedy or claim under this Agreement; and this Agreement shall be for the sole and exclusive benefit of the Company and the Underwriters and any other Holder(s) of the Warrant Certificates or Registrable Securities.

20. Counterparts. This Agreement may be executed in any number of counterparts and each of such counterparts shall for all purposes be deemed to be an original, and such counterparts shall together constitute but one and the same instrument.

*[Remainder of This Page Intentionally Left Blank; Signature Page to Follow]*



IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be duly executed, as of the day and year first above written.

VIRNETX HOLDING CORPORATION

By: \_\_\_\_\_  
Kendall Larsen  
Chief Executive Officer

GILFORD SECURITIES INCORPORATED

By: \_\_\_\_\_  
Robert A. Maley  
President

VIRNETX HOLDING CORPORATION

WARRANT CERTIFICATE

THE WARRANTS REPRESENTED BY THIS CERTIFICATE AND THE OTHER SECURITIES ISSUABLE UPON EXERCISE THEREOF MAY NOT BE OFFERED OR SOLD EXCEPT PURSUANT TO (i) AN EFFECTIVE REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933, AS AMENDED, (ii) TO THE EXTENT APPLICABLE, RULE 144 UNDER SUCH ACT (OR ANY SIMILAR RULE UNDER SUCH ACT RELATING TO THE DISPOSITION OF SECURITIES), OR (iii) AN OPINION OF COUNSEL, IF SUCH OPINION SHALL BE REASONABLY SATISFACTORY TO COUNSEL FOR THE ISSUER, THAT AN EXEMPTION FROM REGISTRATION UNDER SUCH ACT IS AVAILABLE.

**THE TRANSFER OR EXCHANGE OF THE WARRANTS REPRESENTED BY THIS CERTIFICATE IS RESTRICTED IN ACCORDANCE WITH THE WARRANT AGREEMENT REFERRED TO HEREIN.**

EXERCISABLE ON OR BEFORE

5:30 P.M. EASTERN TIME ON [NOVEMBER \_\_, 2012]

NO. W- \_\_\_\_\_ Warrants

This Warrant Certificate ("Warrant Certificate") certifies that Gilford Securities Incorporated, or its assigns, is the registered holder ("Holder") of Warrants (as defined in the Warrant Agreement between the Company and Holder dated as of [November \_\_, 2007] (the "Warrant Agreement")) of VirnetX Holding Corporation (the "Company"). Each Warrant permits Holder to purchase, at any time from [November \_\_, 2008] ("Purchase Date") until 5:30 p.m. Eastern Time on [November \_\_, 2012] (the "Expiration Time"), one share of the Company's Common Stock (the "Shares") at the initial exercise price, subject to adjustment in certain events, of \$\_\_ per share (120% of the public offering price) (the "Exercise Price").

No Warrant may be exercised after the Expiration Time, at which time all Warrants evidenced hereby, unless exercised prior thereto, shall thereafter be void.

The Warrants evidenced by this Warrant Certificate are part of a duly authorized issue of Warrants issued pursuant to the Warrant Agreement. Capitalized terms used but not otherwise defined herein shall have the meanings assigned to such terms in the Warrant Agreement.

The Warrant Agreement provides that upon the occurrence of certain events, the Exercise Price and the type or number of the Company's securities issuable thereupon may be adjusted.

Upon the exercise of less than all of the Warrants evidenced by this Certificate, the Company shall forthwith issue to Holder a new Warrant Certificate representing such number of unexercised Warrants.

The Company may deem and treat Holder as the absolute owner of this Warrant Certificate (notwithstanding any notation of ownership or other writing hereon made by anyone)

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for the purpose of any exercise hereof, and of any distribution to Holder, and for all other purposes, and the Company shall not be affected by any notice to the contrary.

*[Remainder of This Page Intentionally Left Blank; Signature Page to Follow]*

IN WITNESS WHEREOF, the Company has caused this Warrant Certificate to be duly executed.

Dated as of [November \_\_, 2007]

VIRNETX HOLDING CORPORATION

By: \_\_\_\_\_  
Kendall Larsen  
Chief Executive Officer

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**EXHIBIT A**

**FORM OF SUBSCRIPTION (CASH EXERCISE)**

(To be signed only upon exercise of Warrant)

TO: VimetX Holding Corporation  
5615 Scotts Valley Drive, Suite 110  
Scotts Valley, CA 95066

The undersigned holder of Warrant Certificate number \_\_\_\_\_ (the "Warrant Certificate"), representing \_\_\_\_\_ Warrants (as defined in the Warrant Certificate) of VimetX Holding Corporation (the "Company"), which Warrant Certificate is being delivered herewith, hereby irrevocably elects to purchase \_\_\_\_\_ Shares (as defined in the Warrant Certificate), and herewith makes payment of \$ \_\_\_\_\_ therefore, all in accordance with the Warrant Certificate and the Warrant Agreement referred to in the Warrant Certificate. Certificates for the Shares shall be issued in the name of \_\_\_\_\_ and delivered to the following address:

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

By: \_\_\_\_\_  
Name: \_\_\_\_\_  
Social Security Number or Tax Identification Number: \_\_\_\_\_  
Date: \_\_\_\_\_

(Signature must conform in all respects to name of Holder as specified on the face of the Warrant Certificate)

**Address**

Social Security Number or  
Tax Identification Number

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**EXHIBIT B**

**FORM OF SUBSCRIPTION (CASHLESS EXERCISE)**

TO: VimetX Holding Corporation  
5615 Scotts Valley Drive, Suite 110  
Scotts Valley, CA 95066

The undersigned holder of Warrant Certificate number \_\_\_\_\_ (the "Warrant Certificate"), representing \_\_\_\_\_ Warrants (as defined in the Warrant Certificate) of VimetX Holding Corporation (the "Company"), which Warrant Certificate is being delivered herewith, hereby irrevocably elects to purchase (on a cashless exercise basis in accordance with the formula set forth in Section 3.1(b) of the Warrant Agreement referred to in the Warrant Certificate (the "Warrant Agreement")) \_\_\_\_\_ Shares (as defined in the Warrant Certificate), all in accordance with the Warrant Certificate and the Warrant Agreement. Certificates for the Shares shall be issued in the name of \_\_\_\_\_ and delivered to the following address:

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

By: \_\_\_\_\_  
Name: \_\_\_\_\_  
Social Security Number or Tax Identification Number: \_\_\_\_\_  
Date: \_\_\_\_\_

(Signature must conform in all respects to name of Holder as specified on the face of the Warrant Certificate)

**Address**

Social Security Number or  
Tax Identification Number

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**FORM OF ASSIGNMENT**

(To be exercised by the registered holder if such Holder desires to transfer the Warrant Certificate)

FOR VALUE RECEIVED \_\_\_\_\_ hereby sells, assigns and transfers unto:

**Print Name of Transferee**

**Address**

**City State Zip Code**

this Warrant Certificate, together with all right, title and interest therein, and does hereby irrevocably constitute and appoint \_\_\_\_\_ Attorney, to transfer the within Warrant Certificate on the books of the within-named Company, with full power of substitution.

Dated: \_\_\_\_\_

Signature: \_\_\_\_\_

(Signature must conform in all respects to name of Holder as specified on the face of the Warrant Certificate)

Social Security Number or Other Identifying Number of Assignee

October 11, 2007

PASW, Inc.  
5615 Scotts Valley Drive, Suite 110  
Scotts Valley, CA 95066

Re: Registration Statement on Form SB-2

Ladies and Gentlemen:

We are acting as counsel for PASW, Inc., a Delaware corporation (the "Company"), in connection with the registration under the Securities Act of 1933, as amended, of up to 3,000,000 shares of common stock of the Company to be offered and sold by the Company (the "Primary Shares") and up to 5,600,000 shares of common stock of the Company to be offered and sold by certain stockholders of the Company (the "Secondary Shares"). In this regard we have participated in the preparation of a Registration Statement on Form SB-2 relating to the Primary Shares and the Secondary Shares. Such Registration Statement, as amended, is herein referred to as the "Registration Statement."

We have examined instruments, documents, and records which we deemed relevant and necessary for the basis of our opinion hereinafter expressed. In such examination, we have assumed the following: (a) the authenticity of original documents and the genuineness of all signatures; (b) the conformity to the originals of all documents submitted to us as copies; and (c) the truth, accuracy, and completeness of the information, representations, and warranties contained in the records, documents, instruments, and certificates we have reviewed.

Based on such examination, we are of the opinion that the Primary Shares, when issued and sold as described in the Registration Statement, will be legally issued, fully paid and nonassessable, and the Secondary Shares have been legally issued and are fully paid and nonassessable.

We hereby consent to the filing of this opinion as an exhibit to the above-referenced Registration Statement and to the use of our name wherever it appears in said Registration Statement, including the Prospectus constituting a part thereof, as originally filed or as subsequently amended or supplemented. In giving such consent, we do not consider that we are "experts" within the meaning of such term as used in the Securities Act of 1933, as amended, or the rules and regulations of the Securities and Exchange Commission issued thereunder, with respect to any part of the Registration Statement, including this opinion as an exhibit or otherwise.

Very truly yours,

/s/ ORRICK, HERRINGTON & SUTCLIFFE LLP



List of Subsidiaries of VirnetX Holding Corporation:

- o Alera Systems, Inc., formerly iApplianceNet.com, a California Corporation;
- o Network Research Corp. Japan, Ltd.;
- o Pacific Acquisition Corporation, a California Corporation;
- o PASW Europe Limited, a United Kingdom Corporation;
- o VirnetX, Inc., a Delaware Corporation

**CONSENT OF INDEPENDENT ACCOUNTANTS**

We hereby consent to the use in this Amendment No. 2 to Registration Statement on Form SB-2 of our report (which contains an explanatory paragraph relating to VirnetX, Inc.'s ability to continue as a going concern as described in Note 2 to the financial statements) dated April 30, 2007, relating to the financial statements of VirnetX, Inc. as of December 31, 2005 and 2006 and for the period from August 2, 2005 (date of inception) to December 31, 2005 and the years ended 2006, which appears in such Registration Statement. We also consent to the reference to us under the heading "Experts" in such Registration Statement.

/s/ Burr, Pilger & Mayer, LLP  
Palo Alto, CA  
November 2, 2007

**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

We hereby consent to the use in this Amendment No. 2 to Registration Statement on Form SB-2 of our report (which contains an explanatory paragraph relating to the ability of VirnetX Holding Corporation (formerly, PASW, Inc.) to continue as a going concern as described in Note 11 to the financial statements) dated March 28, 2007, relating to the financial statements of VirnetX Holding Corporation as of December 31, 2006 and 2005 and for years then ended, which appears in such Registration Statement. We also consent to the reference to us under the heading "Experts" in such Registration Statement.

/s/ Farber Hass Hurley & McEwen LLP  
Granada Hills, CA  
November 2, 2007