

ST. BERNARD SOFTWARE, INC.  
Form 10-Q  
May 07, 2010

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

FORM 10-Q

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

For the quarterly period ended March 31, 2010

OR

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

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

COMMISSION FILE NUMBER 000-50813

St. Bernard Software, Inc.  
(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

20-0996152  
(I.R.S. Employer  
Identification No.)

15015 Avenue of Science, San Diego, CA 92128  
(Address of principal executive offices)

(858) 676-2277  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports); and (2) has been subject to such filing requirements for the past 90 days.

Yes

No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller Reporting  
Company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

The registrant had 13,391,439 shares of its common stock, par value \$0.01 per share, outstanding at May 7, 2010.

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ST. BERNARD SOFTWARE, INC.

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## PART I – FINANCIAL INFORMATION

## Item 1. Consolidated Financial Statements

St. Bernard Software, Inc.

Consolidated Balance Sheets

	March 31, 2010 (Unaudited)	December 31, 2009
<b>Assets</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 2,786,000	\$ 2,454,000
Accounts receivable - net of allowance for doubtful accounts of \$12,000 and \$13,000 at March 31, 2010 and December 31, 2009, respectively	2,780,000	2,534,000
Inventories - net	216,000	242,000
Prepaid expenses and other current assets	322,000	335,000
<b>Total current assets</b>	<b>6,104,000</b>	<b>5,565,000</b>
<b>Fixed Assets - Net</b>	<b>510,000</b>	<b>564,000</b>
<b>Other Assets</b>	<b>398,000</b>	<b>148,000</b>
Goodwill	7,568,000	7,568,000
<b>Total Assets</b>	<b>\$ 14,580,000</b>	<b>\$ 13,845,000</b>
<b>Liabilities and Stockholders' Deficit</b>		
<b>Current Liabilities</b>		
Short-term borrowings	\$ 2,350,000	\$ 2,250,000
Accounts payable	915,000	817,000
Accrued compensation	948,000	834,000
Accrued expenses and other current liabilities	748,000	597,000
Warranty liability	193,000	192,000
Current portion of capitalized lease obligations	-	22,000
Deferred revenue	10,145,000	10,209,000
<b>Total current liabilities</b>	<b>15,299,000</b>	<b>14,921,000</b>
Deferred Revenue	8,165,000	7,708,000
<b>Total liabilities</b>	<b>23,464,000</b>	<b>22,629,000</b>
<b>Commitments and Contingencies (Note 10)</b>		

Stockholders' Deficit		
Preferred stock, \$0.01 par value; 5,000,000 shares authorized; no shares issued and outstanding	-	-
Common stock, \$0.01 par value; 50,000,000 shares authorized; 13,391,439 and 13,319,991 shares issued and outstanding at March 31, 2010 and December 31, 2009, respectively	133,000	132,000
Additional paid-in capital	40,822,000	40,774,000
Accumulated deficit	(49,839,000 )	(49,690,000 )
Total stockholders' deficit	(8,884,000 )	(8,784,000 )
Total Liabilities and Stockholders' Deficit	\$ 14,580,000	\$ 13,845,000

See accompanying notes to the consolidated financial statements.

St. Bernard Software, Inc.

## Unaudited Consolidated Statements of Operations

	Three months ended March 31,	
	2010	2009
<b>Revenues</b>		
Subscription	\$ 3,496,000	\$ 3,689,000
Appliance	883,000	754,000
License	9,000	6,000
<b>Total Revenues</b>	<b>4,388,000</b>	<b>4,449,000</b>
<b>Cost of Revenues</b>		
Subscription	393,000	461,000
Appliance	600,000	536,000
License	2,000	2,000
<b>Total Cost of Revenues</b>	<b>995,000</b>	<b>999,000</b>
<b>Gross Profit</b>	<b>3,393,000</b>	<b>3,450,000</b>
Sales and marketing expenses	1,730,000	1,660,000
Research and development expenses	788,000	1,148,000
General and administrative expenses	985,000	1,194,000
<b>Total Operating Expenses</b>	<b>3,503,000</b>	<b>4,002,000</b>
<b>Loss from Operations</b>	<b>(110,000 )</b>	<b>(552,000 )</b>
<b>Other Expense (Income)</b>		
Interest expense - net	41,000	92,000
Other income - net	(2,000 )	(16,000 )
<b>Total Other Expense</b>	<b>39,000</b>	<b>76,000</b>
<b>Loss Before Income Taxes</b>	<b>(149,000 )</b>	<b>(628,000 )</b>
<b>Income tax expense</b>	<b>-</b>	<b>(5,000 )</b>
<b>Net Loss</b>	<b>\$ (149,000 )</b>	<b>\$ (633,000 )</b>
<b>Loss Per Common Share - Basic and Diluted</b>	<b>\$ (0.01 )</b>	<b>\$ (0.04 )</b>
<b>Weighted Average Shares Outstanding - Basic and Diluted</b>	<b>13,388,264</b>	<b>14,837,699</b>

See accompanying notes to the consolidated financial statements.

St. Bernard Software, Inc.

## Unaudited Consolidated Statement of Stockholders' Deficit

	Common Stock		Additional	Accumulated	Total
	Shares	Amount	Paid-in Capital	Deficit	
Balance at December 31, 2009	13,319,991	\$ 132,000	\$ 40,774,000	\$ (49,690,000)	\$ (8,784,000)
Common stock issued under the employee stock purchase plan	71,448	1,000	11,000	-	12,000
Stock-based compensation expense	-	-	37,000	-	37,000
Net loss	-	-	-	(149,000 )	(149,000 )
Balance at March 31, 2010	13,391,439	\$ 133,000	\$ 40,822,000	\$ (49,839,000)	\$ (8,884,000)

See accompanying notes to the consolidated financial statements.



St. Bernard Software, Inc.

## Unaudited Consolidated Statements of Cash Flows

	Three months ended March 31,	
	2010	2009
<b>Cash Flows From Operating Activities</b>		
Net loss	\$ (149,000 )	\$ (633,000 )
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	85,000	104,000
Allowance for doubtful accounts	(1,000 )	(2,000 )
Gain on change in fair value of warrant derivative liability	(2,000 )	(16,000 )
Stock-based compensation expense	37,000	357,000
Noncash interest expense	15,000	38,000
Increase (decrease) in cash resulting from changes in:		
Accounts receivable	(245,000 )	573,000
Inventories	26,000	(73,000 )
Prepaid expenses and other assets	(252,000 )	(421,000 )
Accounts payable	98,000	267,000
Accrued expenses and other current liabilities	153,000	30,000
Accrued compensation	114,000	(410,000 )
Warranty liability	1,000	(16,000 )
Deferred revenue	393,000	(461,000 )
Net cash provided (used) by operating activities	273,000	(663,000 )
<b>Cash Flows From Investing Activities</b>		
Purchases of fixed assets	(31,000 )	(63,000 )
Net cash used by investing activities	(31,000 )	(63,000 )
<b>Cash Flows From Financing Activities</b>		
Proceeds from the sales of stock under the employee stock purchase plan	12,000	9,000
Principal payments on capitalized lease obligations	(22,000 )	(42,000 )
Net increase (decrease) in short-term borrowings	100,000	(362,000 )
Net cash (used) provided by financing activities	90,000	(395,000 )
Net Increase (Decrease) in Cash and Cash Equivalents	332,000	(1,121,000 )
Cash and Cash Equivalents at Beginning of Period	2,454,000	2,051,000
Cash and Cash Equivalents at End of Period	\$ 2,786,000	\$ 930,000
<b>Supplemental Disclosures of Cash Flow Information:</b>		
Cash paid during the period for:		
Interest	\$ 17,000	\$ 34,000

Income taxes	\$	-	\$	3,000
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Non Cash Investing and Financing Activities:

In January 2009, the Company reclassified 463,500 warrants with an estimated fair value of \$41,000 from equity to warrant derivative liability.

See accompanying notes to the consolidated financial statements.

St. Bernard Software, Inc.

Notes to Consolidated Financial Statements

1. Summary of Significant Accounting Policies

St. Bernard Software, Inc., a Delaware corporation (“we,” “us,” “our,” the “Company,” or “St. Bernard”) is a software development company that designs, develops, and markets Secure Web Gateway (“SWG”) appliances and policy compliance solutions to small, medium, and enterprise class customers. The Company sells its products through distributors, dealers, and original equipment manufacturers (“OEMs”), and directly to network managers and administrators worldwide.

Basis of presentation

The consolidated balance sheet as of March 31, 2010, the consolidated statements of operations for the three months ended March 31, 2010 and 2009, the consolidated statement of stockholders’ deficit for the three months ended March 31, 2010, and the consolidated statements of cash flows for the three months ended March 31, 2010 and 2009, are unaudited and have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information, the instructions to Form 10-Q and applicable sections of Regulation S-X. The interim financial statements reflect all adjustments which are, in the opinion of management, necessary to make the financial statements not misleading. The consolidated balance sheet as of December 31, 2009 was derived from the Company’s audited financial statements. Operating results for the interim periods presented are not necessarily indicative of results to be expected for the fiscal year ending December 31, 2010. These consolidated financial statements should be read in conjunction with the Company’s December 31, 2009 consolidated financial statements and notes thereto included in the Company’s Annual Report filed on Form 10-K with the Securities and Exchange Commission on March 26, 2010.

The accompanying consolidated financial statements include the accounts of the Company and those of our inactive wholly-owned European and Australian subsidiaries which were closed in 2007. All inter-company balances and transactions have been eliminated in consolidation.

Use of estimates

The preparation of the consolidated financial statements in conformity with U.S generally accepted accounting principles (“U.S. GAAP”) requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates. Significant estimates used in preparing the consolidated financial statements include those assumed in computing revenue recognition, the allowance for doubtful accounts, warranty liability, the valuation allowance on deferred tax assets, testing goodwill for impairment, and stock-based compensation.

Liquidity

As of March 31, 2010, the Company had approximately \$2.8 million in cash and cash equivalents and a working capital deficit of \$9.2 million. Approximately \$10.1 million of our current liability balance at March 31, 2010 consisted of deferred revenues, which represents amounts that are expected to be amortized into revenue as they are earned in future periods. For the three months ended March 31, 2010, the Company incurred a net loss of \$149,000, and through March 31, 2010 has recorded a cumulative net loss of \$49.8 million. For the three months ended March 31, 2010 cash provided by operating activities was \$273,000.

In an effort to achieve profitability, the Company has made and continues to make substantial changes to the cost structure of its business. These changes include monitoring headcount to be in line with the current size of its business, renegotiating vendor contracts, and refocusing its marketing strategy around its core business. These efforts contributed to a significant reduction in the Company's net loss and the positive cash flow from operating activities in 2010. As described at Note 4, the Company has existing credit facilities with Silicon Valley Bank ("SVB") and Partners for Growth, LP ("PFG"), under which there is borrowing availability of \$640,000 and \$750,000, respectively, as of March 31, 2010.

The Company believes that its existing cash resources, combined with projected collections on billings, and borrowing availability under existing credit facilities, will provide sufficient liquidity for the Company to meet its continuing obligations for the next twelve months. However, there can be no assurances that projected collections will be achieved or the improvement in operating results or cash flows from operating activities will continue. In the event cash flow from operating activities and additional borrowings under existing credit facilities are not sufficient, the Company may require additional sources of financing in order to maintain its current operations. These additional sources of financing may include public or private offerings of equity or debt securities. In the current capital environment, no assurance can be given that additional sources of financing will be available on acceptable terms, on a timely basis, or at all.

#### Basic and diluted loss per common share

Basic loss per common share is calculated by dividing the net loss for the period by the weighted average number of shares of common stock outstanding during the period. The Company computes diluted loss per common share by dividing the net loss for the period by the weighted average number of common and dilutive potential common shares outstanding during the period. Dilutive potential common shares consist of stock options and warrants (See Notes 2 and 4). Dilutive stock options and dilutive warrants are calculated based on the average share price for each fiscal period using the treasury stock method which assumes that the proceeds from the exercise of outstanding options and warrants are used to purchase common stock at market value. There was no dilutive effect calculated for three months ended March 31, 2010 and 2009 as the Company reported a net loss in each period and as such the inclusion of dilutive potential common shares would have been anti-dilutive.

St. Bernard Software, Inc.

Notes to Consolidated Financial Statements

Fair value of financial instruments

The Company's financial instruments consist of cash and cash equivalents, accounts receivable, accounts payable, accrued expenses, credit facility agreements, capital lease agreements and warrant liability. The fair values of cash and cash equivalents, accounts receivable, accounts payable and accrued expenses approximate their respective carrying values due to the short-term maturities of these instruments. The fair value of the Company's obligations under its line of credit and capital leases approximates their carrying value as the stated interest rates of these instruments reflect rates which are otherwise currently available to the Company. The fair value of warrant instruments classified as liabilities is measured at each reporting period, and the corresponding change in fair value is recorded in current earnings (See Notes 5 and 6).

Adopted Accounting Pronouncements

In January 2010, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2010-06, "Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements", amending ASC 820. ASU 2010-06 requires entities to provide new disclosures and clarify existing disclosures relating to fair value measurements. The new disclosures and clarifications of existing disclosures are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in Level 3 fair value measurements, which are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years.

New accounting standards

In October 2009, the FASB issued ASU No. 2009-14, "Certain Revenue Arrangements That Include Software Elements" ("ASU 2009-14"). ASU 2009-14 changes the accounting model for revenue arrangements that include both tangible products and software elements that are "essential to the functionality," and scopes these products out of current software revenue guidance. The new guidance will include factors to help companies determine what software elements are considered "essential to the functionality." The amendments will now subject software-enabled products to other revenue guidance and disclosure requirements, such as guidance surrounding revenue arrangements with multiple-deliverables. The amendments for ASU 2009-14 are effective prospectively for revenue arrangements entered into or materially modified in the fiscal years beginning on or after June 15, 2010. Early application is permitted. We are currently evaluating the impact, if any, the adoption of ASU 2009-14 will have on our consolidated financial statements.

In October 2009, the FASB issued ASU No. 2009-13, "Multiple-Deliverable Revenue Arrangements" ("ASU 2009-13"). ASU 2009-13 establishes the accounting and reporting guidance for arrangements including multiple revenue-generating activities. This ASU provides amendments to the criteria for separating deliverables, measuring and allocating arrangement consideration to one or more units of accounting. The amendments in this ASU also establish a selling price hierarchy for determining the selling price of a deliverable. Significantly enhanced disclosures are also required to provide information about a vendor's multiple-deliverable revenue arrangements, including information about the nature and terms, significant deliverables, and its performance within arrangements. The amendments also require providing information about the significant judgments made and changes to those judgments and about how the application of the relative selling-price method affects the timing or amount of revenue recognition. The amendments in ASU 2009-13 are effective prospectively for revenue arrangements entered into or materially modified in the fiscal years beginning on or after June 15, 2010. We are currently evaluating the impact, if any, the

adoption of ASU 2009-13 will have on our consolidated financial statements.

Other new accounting standards that have been issued by the FASB or other standards-setting bodies are not expected to have a material impact on the Company's consolidated financial statements.

#### Reclassifications

Certain prior year reclassifications have been made for consistent presentation. These reclassifications had no effect on previously reported results of operations or stockholders' deficit.

#### 2. Stock-Based Compensation Expense

Effective January 1, 2006, the Company adopted the fair value recognition provisions as codified in ASC 718 (formerly SFAS No. 123R (revised 2004)), "Compensation – Stock Compensation", using the modified prospective method. Stock-based compensation expense for all stock-based compensation awards granted after January 1, 2006 is based upon the estimated grant date fair value, as described below.

The Company has non-qualified and incentive stock option plans (together, the "Plans") providing for the issuance of options to employees and others as deemed appropriate by the Board of Directors. Terms of options issued under the Plans include an exercise price equal to the estimated fair value (as determined by the Board of Directors) at the date of grant, vesting periods generally between three and five years, and expiration dates not to exceed ten years from the date of grant. The determination of fair value of the Company's stock is derived using the stock price at the grant date.

## St. Bernard Software, Inc.

## Notes to Consolidated Financial Statements

In 2005, the Company adopted the St. Bernard Software 2005 Stock Option Plan (the “2005 Plan”). Under the 2005 Plan, the Company has the ability to grant 3,074,215 shares of its common stock to employees and others. The 2005

Plan permits the grant of incentive stock options and non-qualified stock options. The exercise price of options granted under the 2005 Plan can generally not be less than the fair market value of the Company’s common stock on the date of grant. If any of the granted options expire or terminate for any reason without having been exercised in full, the unpurchased shares shall again be available for purposes of this Plan. During the three months ended March 31, 2010 and 2009, no options were exercised and 93,982 and 307,222 options were forfeited, respectively. As of March 31, 2010, the Company had 2,622,567 option shares outstanding and 451,648 option shares available for issuance under the 2005 Plan.

Calculating stock-based compensation expense requires the input of highly subjective assumptions, including the expected life of the stock options granted, the expected stock price volatility factor, and the pre-vesting option forfeiture rate. The fair value of options granted during the three months ended March 31, 2010 and 2009 was calculated using the Black-Scholes option pricing model using the valuation assumptions in the table below. The Company estimates the expected life of stock options granted based upon management’s consideration of the historical life of the options and the vesting and contractual period of the options granted. The Company estimates the expected volatility factor based on the weighted average of the historical volatility of three publicly traded surrogates of the Company and the Company’s implied volatility from its common stock price. The Company applies its risk-free interest rate based on the U.S. Treasury yield in effect at the time of the grant. The Company has no history or expectation of paying any cash dividends on its common stock. Forfeitures are estimated based on historical experience.

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
Average expected life (years)	6.5	6.5
Average expected volatility	49.9%	74.1%
Average risk-free interest rate	3.8%	2.6%
Average expected dividend yield	0	0

Total stock-based compensation expense was approximately \$37,000 and \$357,000 for the three months ended March 31, 2010 and 2009, respectively. The decrease in stock-based compensation expense was mainly due to the expiring options for a former executive officer of the Company. The stock-based compensation expenses were charged to operating expenses. The effect on loss per share as a result of the stock based compensation expense was approximately \$0.00 and \$0.02 for the three months ended March 31, 2010 and 2009, respectively. The tax effect was immaterial.

The following is a summary of stock option activity under the Plans as of December 31, 2009 and changes during the three months ended March 31, 2010:

	Number of Shares Outstanding	Weighted Average Exercise Price
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Options outstanding at December 31, 2009	2,455,049	\$	0.22
Granted	261,500	\$	0.20
Exercised	—	\$	—
Forfeited	(93,982)	\$	0.25
Options outstanding at March 31, 2010	2,622,567	\$	0.22
Options exercisable at March 31, 2010	1,125,440	\$	0.24

Additional information regarding options outstanding as of March 31, 2010 is as follows:

Exercise Prices	Number of Shares Outstanding	Weighted Average Remaining Contractual Life in Years	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$ 0.14	5,000	9.96	\$ 0.14	—	\$ —
\$ 0.15	192,000	9.01	\$ 0.15	50,416	\$ 0.15
\$ 0.16	292,750	9.72	\$ 0.16	—	\$ —
\$ 0.18	33,000	9.88	\$ 0.18	—	\$ —
\$ 0.19	9,500	9.05	\$ 0.19	2,507	\$ 0.19
\$ 0.20	395,000	9.44	\$ 0.20	55,555	\$ 0.20
\$ 0.22	103,000	9.83	\$ 0.22	5,554	\$ 0.22
\$ 0.24	240,000	9.58	\$ 0.24	20,000	\$ 0.24
\$ 0.25	1,346,317	7.38	\$ 0.25	991,408	\$ 0.25
\$ 0.26	6,000	9.48	\$ 0.26	—	\$ —
	2,622,567	8.42	\$ 0.22	1,125,440	\$ 0.24



St. Bernard Software, Inc.

Notes to Consolidated Financial Statements

The aggregate intrinsic value of options outstanding and options exercisable at March 31, 2010 was approximately \$22,000 and \$3,000, respectively. The aggregate intrinsic value represents the total intrinsic value based upon the stock price of \$0.20 at March 31, 2010. There was no aggregate intrinsic value of options outstanding and options exercisable as of March 31, 2009 based on a stock price of \$0.13 at March 31, 2009.

As of March 31, 2010, there was approximately \$236,000 of total unrecognized compensation expense related to unvested share-based compensation arrangements granted under the option plans. The cost is expected to be recognized over a weighted average period of 2.22 years.

### 3. Credit Facilities

#### Silicon Valley Bank (“SVB”)

On May 15, 2007, the Company entered into a Loan and Security Agreement with SVB (the “SVB Loan Agreement”) which provides for a credit facility not to exceed \$2.0 million, subject to a borrowing base formula. The SVB Loan Agreement was amended on February 27, 2009 (the “SVB Loan Amendment”). Pursuant to the terms of the SVB Loan Amendment, among other things, SVB (i) decreased the interest rate on the revolving line of credit to the greater of 3.50% over the prime rate or 7.5% (from the greater of 3% over the prime rate or 10.5%), (ii) modified the tangible net worth covenant to no less than negative seventeen million dollars (\$17,000,000) at all times, increasing quarterly by fifty percent (50%) of net income and monthly by fifty percent (50%) of issuances of equity after January 31, 2009 and the principal amount of subordinated debt received after January 31, 2009, (iii) modified the borrowing base to seventy percent (70%) of eligible accounts and the lesser of sixty percent (60%) of advanced billing accounts or six hundred thousand dollars (\$600,000) as determined by SVB; provided, however, that SVB may, with notice to the Company, decrease the foregoing percentage in its good faith business judgment based on events, conditions, contingencies, or risks which, as determined by SVB, may adversely affect collateral, and (iv) extended the revolving line maturity date to May 15, 2010.

In March 2010, the SVB Loan Agreement was amended. Pursuant to the terms of the Loan Amendment, among other things, SVB (i) increased the revolving line balance to \$2.3 million (from \$2.0 million), (ii) decreased the interest rate on the revolving line of credit to 2.0% (from 3.5%) over the greater of the SVB prime rate or 6.0% (from 7.5%), (iii) modified the tangible net worth covenant to no less than negative eighteen million dollars (\$18,000,000) at all times, increasing quarterly by fifty percent (50%) of net income and monthly by fifty percent (50%) of issuances of equity after January 31, 2010 and the principal amount of subordinated debt received after January 31, 2010, (iv) modified the borrowing base to eighty percent (80%) of eligible accounts, and (v) extended the revolving line maturity date to May 15, 2011. At March 31, 2010, total availability under the SVB Loan Agreement was \$2.2 million, of which \$1.6 million was outstanding, with an applicable interest rate was 6.0%. The Company was in compliance with the above stated covenants and restrictions. The obligations under the SVB Loan Agreement are secured by substantially all of St. Bernard’s assets.

In addition, the Loan Amendment provides for two additional term loan facilities totaling \$500,000 that can only be used to repay indebtedness owing from the Company to Partners for Growth. Term Loan A, in the amount of \$300,000, accrues interest at a floating per annum rate equal to the greater of two percentage points (2.00%) above the SVB prime rate or six percent (6.00%). Term Loan B, in the amount of \$200,000, accrues interest at a floating per annum rate equal to the greater of three and one half percentage points (3.50%) above the SVB prime rate or seven and one half percent (7.50%).

In connection with the execution of a previous SVB Loan Amendment dated January 25, 2008, St. Bernard issued warrants to SVB which allows SVB to purchase up to 140,350 shares of our common stock at an exercise price of \$0.57 per share. The warrants expire on the seventh anniversary of their issue date. We recorded deferred debt issuance costs in the amount of \$58,000, based on the estimated fair value allocated to the warrants using the following assumptions; 75.35% volatility, risk free interest rate of 3.61%, an expected life of seven years and no dividends. Amortization of the debt issuance costs, including amounts recorded as a debt discount for warrants previously issued, for the three months ended March 31, 2010 and 2009, which is being recorded as interest expense, was approximately \$0 and \$23,000, respectively. Furthermore, St. Bernard agreed to grant SVB certain piggyback registration rights with respect to the shares of common stock underlying the warrants.

#### Partners for Growth II, LP (“PFG”)

On July 21, 2008, the Company entered into a Loan Agreement with PFG (the “PFG Loan Agreement”), which became effective on July 23, 2008 and which provides for a credit facility not to exceed \$1.5 million, subject to a borrowing base formula. The PFG Loan Agreement was subsequently amended on February 27, 2009. The annual interest rate on the PFG Loan is set at the Prime Rate, quoted by SVB as its Prime Rate, plus 3% (the “Applicable Rate”). At March 31, 2010, the effective interest rate was 7%. The PFG Loan Agreement will terminate on July 20, 2010, on which date all principal, interest and other outstanding monetary obligations must be repaid to PFG. The obligations under the PFG Loan Agreement are secured by a security interest in collateral comprised of substantially all of St. Bernard’s assets, subordinated to the SVB Loan Agreement.

The PFG Loan Agreement contains affirmative, negative and financial covenants customary for credit facilities of this type, including, among other things, limitations on indebtedness, liens, sales of assets, mergers, investments, and dividends. The PFG Loan Agreement also requires that St. Bernard maintain a Modified Net Income (as defined in the PFG Loan Agreement) greater than zero. PFG eliminated the Modified Net Income covenant for the reporting periods ending February 28, 2009 and March 31, 2009. The PFG Loan Agreement contains events of default customary for credit facilities of this type (with customary grace or cure periods, as applicable) and provides that upon the occurrence and during the continuance of an event of default, among other things, the interest rate on all borrowings will be increased, the payment of all borrowings may be accelerated, PFG’s commitments may be terminated and PFG shall be entitled to exercise all of its rights and remedies, including remedies against collateral. At March 31, 2010, the Company was in compliance with the above stated covenants.

## St. Bernard Software, Inc.

## Notes to Consolidated Financial Statements

In connection with the execution of the PFG Loan Agreement, St. Bernard received approximately \$1,000 from PFG, and as a result, issued a warrant to PFG on July 21, 2008 (the "Warrant"), which allows PFG to purchase up to 450,000 shares of St. Bernard common stock at an exercise price equal to \$0.46 per share. The Warrant expires on July 20, 2013. The Company recorded deferred debt issuance costs in the amount of \$125,000, based on the estimated fair value allocated to the warrants using the following assumptions; 69.07% volatility, risk free interest rate of 4.09%, an expected life of five years and no dividends. Amortization of the debt issuance costs for the three months ended March 31, 2010 and 2009, which is being recorded as interest expense, was approximately \$15,000 and \$16,000, respectively. As of March 31, 2010, total availability under the PFG Loan Agreement was \$1.5 million, of which \$750,000 was outstanding.

## 4. Stockholders' Deficit

## Warrants

As of March 31, 2010 and December 31, 2009, a total of 1,153,850 shares of common stock were reserved for issuance for the exercise of warrants at exercise prices ranging from \$0.46 to \$1.60 per share. There were no warrants granted, exercised, or cancelled during the three months ended March 31, 2010.

The following is a summary of our warrants activity as of December 31, 2009 and changes during the three months ended March 31, 2010:

	Number of Shares	Per Share Exercise Price Range	Weighted Average Exercise Price
Outstanding warrants - December 31, 2009	1,153,850	\$ 0.46-1.60	\$ 0.62
Granted	—	—	—
Expired and/or cancelled	—	—	—
Outstanding warrants - March 31, 2010	1,153,850	\$ 0.46-1.60	\$ 0.62
Warrants exercisable - March 31, 2010	1,153,850	\$ 0.46-1.60	\$ 0.62

## 5. Warrant Derivative Liability

At March 31, 2010, there were 463,500 warrants classified as a derivative liability pursuant to accounting guidance as codified in ASC 815-40 (formerly EITF Issue No. 07-5, "Determining Whether an Instrument (or Embedded Feature) is Indexed to an Entity's Own Stock"). At March 31, 2010 the estimated fair value of the warrants, which is included in accrued expenses and other current liabilities in the accompanying balance sheet, was determined based on a Black-Scholes option pricing model, to be \$17,000 (See Note 6). The change in the estimated fair value of the warrant derivative liability for the three months ended March 31, 2010 of \$2,000 is included in other income in the accompanying statement of operations.

## 6. Fair Value Measurements

## Fair Value Hierarchy

Fair value is defined in ASC 820 as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value measurements are to be considered from the perspective of a market participant that holds the assets or owes the liability. ASC 820 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The standard describes three levels of inputs that may be used to measure fair value:

Level 1: Quoted prices in active markets for identical or similar assets and liabilities.

Level 2: Quoted prices for identical or similar assets and liabilities in markets that are not active or observable inputs other than quoted prices in active markets for identical or similar assets and liabilities.

Level 3: Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

## St. Bernard Software, Inc.

## Notes to Consolidated Financial Statements

## Financial Instruments Measured at Fair Value on a Recurring Basis

ASC 820 requires disclosure of the level within the fair value hierarchy used by the Company to value financial assets and liabilities that are measured at fair value on a recurring basis. At March 31, 2010 the Company had outstanding warrants to purchase common shares of our stock that are classified as warrant derivative liabilities with a fair value of \$17,000. The warrants are valued using the Black-Scholes option pricing model using the valuation assumptions in the table below.

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
Remaining life (years)	4.8	5.8
Expected volatility	49.9%	78.6%
Risk-free interest rate	3.8%	2.7%
Expected dividend yield	0	0
Stock price	\$ 0.20	\$ 0.13

The following table reconciles the warrant derivative liability measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three months ended March 31, 2010:

Balance at December 31, 2009	\$ 19,000
Gain on change in fair value included in other income	(2,000)
Balance at March 31, 2010	\$ 17,000

## 7. Litigation

In the normal course of business, the Company is occasionally named as a defendant in various lawsuits. On July 9, 2009, an action was filed in the United States District Court for the Southern District of California by Southwest Technology Innovations LLC (the "Plaintiff") against the Company and Espion International, Inc., Workgroup Solutions, Inc., SonicWall, Inc., Mirapoint Software, Inc., and Proofpoint, Inc., (collectively the "Defendants"). In this matter, the Plaintiff's claim against the Company is that the ePrism e-mail filter products, which are manufactured by an unrelated third party and sold by the Company, allegedly infringe upon U.S. Patent No. 6,952,719 entitled "Spam Detector Defeating System" which was issued on October 4, 2005. The Plaintiff is seeking a judgment in Plaintiff's favor, injunctive relief, and an award of unspecified damages. The Company is vigorously defending its interests in this matter.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes that appear elsewhere in this Quarterly Report on Form 10-Q. In addition to historical consolidated financial information, the following discussion contains forward-looking statements that reflect our plans, estimates and beliefs. Our actual results could differ materially from those discussed in the forward-looking statements. Factors that could cause or contribute to these differences include those discussed below and elsewhere in this Quarterly Report on Form 10-Q.

### OVERVIEW

#### Our Business

We design, develop, and market SWG appliances and services that help IT professionals effectively manage their enterprise's Internet-based resources. Incorporated in 1986, the Company has evolved to become a well recognized leader in the SWG market with its iPrism Web Filter. With millions of end users worldwide in approximately 6,000 enterprises, educational institutions, small and medium businesses, and government agencies, the Company strives to deliver simple, high performance solutions that offer excellent value to our customers.

Our customers include approximately 6,000 enterprises, educational institutions, small and medium businesses, and government agencies. Customers can purchase our solutions directly from us, through our 1-tier and 2-tier reseller network, and through OEMs. Appliance purchases typically consist of an initial hardware purchase and maintenance subscription. Our primary customers are IT managers, directors, and administrators.

#### Our Financial Results

We reported revenues of \$4.4 million for the three months ended March 31, 2010 and 2009; a net loss for the three months ended March 31, 2010 of \$149,000, compared to a net loss of \$633,000 for the same period in 2009; and net basic and diluted loss per share for the three months ended March 31, 2010 of \$0.01, compared to a net basic and diluted loss per share of \$0.04 reported in the same period in 2009. The decrease in the basic and diluted loss per share was primarily attributable to a decrease in operating expenses of approximately \$499,000 for the three months ended March 31, 2010 compared to the same period in 2009.

Cash provided by operations increased \$936,000 to \$273,000 for the three months ended March 31, 2010 compared to cash used by operations of \$663,000 for the same period in 2009. The net increase in the cash provided by operations was due primarily to lower operating losses.

In March 2010, we amended our line of credit agreement with SVB which was established on May 15, 2007. See the section below titled "Credit Facilities" for the terms of the original and amended agreement with SVB. The outstanding balance on the line of credit with SVB was \$1.6 million as of March 31, 2010.

During the three months ended March 31, 2010, we continued to invest in product development. Our efforts have been directed toward new feature enhancements as well as the continual improvement of our SWG appliances. Our development efforts were primarily focused on delivering additional security features for our product lines while employing a cost-reduction strategy.

#### Critical Accounting Policies and Estimates

There are several accounting policies that involve management's judgments and estimates and are critical to understanding our historical and future performance as these policies and estimates affect the reported amounts of revenue and other significant areas in our reported financial statements.

revenue recognition;  
allowance for doubtful accounts;  
impairment of goodwill and long-lived assets;  
accounting for income taxes;  
warranty obligation; and  
accounting for stock options.

Please refer to the "Management's Discussion and Analysis of Financial Condition and Results of Operation" located within our 10-K filed on March 26, 2010 for the year ended December 31, 2009 for further discussion of our "Summary of Significant Accounting Policies and Estimates". There have been no material changes to these accounting policies during the three months ended March 31, 2010.

## Results of Operations

Comparisons of the Three Months Ended March 31, 2010 and 2009 (in thousands, except percentages)

## Revenues

	For the Three Months Ended March 31,			
	2010	2009		% Change
Total revenues	\$ 4,388	\$ 4,449		(1.4)%

Revenues decreased \$61,000 for the three months ended March 31, 2010, compared to the same period in 2009 primarily as a result of a decrease of \$193,000 in subscription revenues, offset by an increase of \$129,000 in appliance revenues. See the discussion of changes in subscription and appliance revenues below.

## Subscription Revenues

	For the Three Months Ended March 31,			
	2010	2009		% Change
Subscription revenues	\$ 3,496	\$ 3,689		(5.2)%
As a percentage of total revenues	79.7%	82.9%		

For the three months ended March 31, 2010 our subscription revenues decreased approximately \$193,000 compared to the same period in 2009. This decrease is mainly the result of pricing pressures to discount our subscription products to continue to remain competitive in the current economy. The subscription renewal rates for our products range from 75% to 85%.

## Appliance Revenues

	For the Three Months Ended March 31,			
	2010	2009		% Change
Appliance revenues	\$ 883	\$ 754		17.1%
As a percentage of total revenues	20.1%	16.9%		

For the three months ended March 31, 2010, appliance revenues increased approximately \$129,000 compared with the respective period in 2009. This increase, as well as the increase of 3.2% in gross margin, is due to a noticeable shift towards our higher-end models by our customers as a result of increased bandwidth needs. We expect this increase to continue as the need for additional bandwidth continues to increase.

## Cost of Revenues

For the



	Three Months Ended March 31,		
	2010	2009	% Change
Total cost of revenues	\$ 995	\$ 999	(0.4)%
Gross margin percentage	77.3%	77.5%	

Cost of revenues consist primarily of the cost of contract manufactured hardware, royalties paid to third parties under technology licensing agreements, packaging costs, fee-based technical support costs and freight. Total cost of revenues decreased slightly for the three months ended March 31, 2010 compared to the same period in 2009. See the discussion of changes in the cost of subscription and appliance revenues below.

## Cost of Subscription Revenues

	For the Three Months Ended March 31,			
	2010	2009		% Change
Cost of subscription revenues	\$ 393	\$ 461		(14.8)%
Gross margin percentage	88.8%	87.5%		

The cost of subscription revenues includes the technical support group. The decrease of \$68,000 for three months ended March 31, 2009 to the same period in 2010 is mainly due to a reclassification of the expense related to our iGuard product from the cost of subscription revenues to research and development expense.

## Cost of Appliance Revenues

	For the Three Months Ended March 31,			
	2010	2009		% Change
Cost of appliance revenues	\$ 600	\$ 536		11.9%
Gross margin percentage	32.0%	28.9%		

The cost of appliance revenues, which includes contract manufactured equipment, packaging and freight, increased \$64,000 for the three months ended March 31, 2010 compared to the same period in 2009. This increase, as well as the increase of 3.1% in gross margin, is due to a noticeable shift towards our higher-end models by our customers as a result of increased bandwidth needs. We expect this increase to continue as the need for additional bandwidth continues to increase.

## Sales and Marketing Expense

	For the Three Months Ended March 31,			
	2010	2009		% Change
Sales and marketing expense	\$ 1,730	\$ 1,660		4.2%
As a percentage of total revenues	39.4%	37.3%		

Sales and marketing expense consists primarily of salaries, related benefits, commissions, consultant fees, advertising, lead generation and other costs associated with our sales and marketing efforts. For the three months ended March 31, 2010 sales and marketing expense increased 4.2%, or approximately \$70,000, over the same period in 2009.

## Research and Development Expense

For the  
Three Months Ended  
March 31,

	2010	2009	% Change
Research and development expense \$	788	\$ 1,148	(31.4)%
As a percentage of total revenues	18.0%	25.8%	

Research and development expense consists primarily of salaries, related benefits, third-party consultant fees and other engineering related costs. The decrease of \$360,000 for the three months ended March 31, 2010 compared to the same period in 2009 was primarily the result of a net decrease in compensation costs. During 2009, after making the decision to move research and development in-house, the Company modified its consulting agreement with Softworks Group Pty Ltd. The transition from outside consulting to in-house occurred during the latter half of 2009 and into 2010, resulting in a significant decrease in consulting expenses.

Management believes that a significant investment in research and development is required to remain competitive and we expect to continue to invest in research and development activities.

## General and Administrative Expense

	For the Three Months Ended March 31,			
	2010	2009		% Change
General and administrative expense	\$ 985	\$ 1,194		(17.5)%
As a percentage of total revenues	22.4%	26.8%		

General and administrative expenses, which consist primarily of salaries and related benefits, and fees for professional services, such as legal and accounting services, decreased approximately \$209,000 for the three months ended March 31, 2010, compared to the same period in 2009. The most significant decreases during the current quarter included decreases in stock-based compensation expenses of \$319,000, offset by an increase in compensation and consulting expenses of approximately \$58,000. The decrease in stock-based compensation expenses was mainly attributable to the cancellation of stock options originally granted to the Company's former CEO.

## Interest and Other Income, Net

	For the Three Months Ended March 31,			
	2010	2009		% Change
Interest and other income, net	\$ 39	\$ 76		(48.7)%
As a percentage of total revenues	0.9%	1.7%		

Interest and other income, net, includes interest expense, interest income, and other income. The decrease for the three months ended March 31, 2010 over the same period in 2009 was due to a decrease in short-term borrowings.

## Recent Accounting Pronouncements

In October 2009, the FASB issued ASU No. 2009-14, "Certain Revenue Arrangements That Include Software Elements" ("ASU 2009-14"). ASU 2009-14 changes the accounting model for revenue arrangements that include both tangible products and software elements that are "essential to the functionality," and scopes these products out of current software revenue guidance. The new guidance will include factors to help companies determine what software elements are considered "essential to the functionality." The amendments will now subject software-enabled products to other revenue guidance and disclosure requirements, such as guidance surrounding revenue arrangements with multiple-deliverables. The amendments for ASU 2009-14 are effective prospectively for revenue arrangements entered into or materially modified in the fiscal years beginning on or after June 15, 2010. Early application is permitted. We are currently evaluating the impact, if any, the adoption of ASU 2009-14 will have on our consolidated financial statements.

In October 2009, the FASB issued ASU No. 2009-13, "Multiple-Deliverable Revenue Arrangements" ("ASU 2009-13"). ASU 2009-13 establishes the accounting and reporting guidance for arrangements including multiple revenue-generating activities. This ASU provides amendments to the criteria for separating deliverables, measuring and allocating arrangement consideration to one or more units of accounting. The amendments in this ASU also establish a selling price hierarchy for determining the selling price of a deliverable. Significantly enhanced disclosures are also required to provide information about a vendor's multiple-deliverable revenue arrangements, including

information about the nature and terms, significant deliverables, and its performance within arrangements. The amendments also require providing information about the significant judgments made and changes to those judgments and about how the application of the relative selling-price method affects the timing or amount of revenue recognition. The amendments in ASU 2009-13 are effective prospectively for revenue arrangements entered into or materially modified in the fiscal years beginning on or after June 15, 2010. We are currently evaluating the impact, if any, the adoption of ASU 2009-13 will have on our consolidated financial statements.

## Liquidity and Capital Resources

### Cash Flows

Our largest source of operating cash flows is cash receipts from our customers from purchases of products, subscription, maintenance and technical support. Our standard payment terms for both subscription and support invoices are net 30 days from the date of invoice but from time to time we enter into payment terms that are greater than 30 days. The recurring subscription portion of our business provides predictable cash flow but new sales fluctuate due to seasonal buying behavior and sales and marketing effectiveness. Our primary uses of cash for operating activities include cost associated with appliance sales and appliance warranty, costs to maintain our subscription services, personnel, facilities, sales and marketing, research and development, and general and administrative expenses.

Cash provided by operations was \$273,000 for the three months ended March 31, 2010 and cash used by operations was \$663,000 for the same period in 2009. The net decrease in use of cash was due primarily to lower operating losses.

For the three months ended March 31, 2010 and 2009, cash used in investing activities was \$31,000 and \$63,000, respectively, for purchases of fixed assets.

Cash flows provided by financing activities for the three months ended March 31, 2010 was \$90,000 and cash used by financing activities for the same period in 2009 was \$395,000. The increase in cash provided by financing was primarily due to the net increase in short-term borrowings.

As a result of the foregoing, the net increase in cash and cash equivalents was \$332,000 for the three months ended March 31, 2010 as compared to a net decrease in cash of approximately \$1.1 million for the comparable period in 2009.

#### Credit Facilities

##### Silicon Valley Bank

On May 15, 2007, the Company entered into a Loan and Security Agreement with SVB (the "SVB Loan Agreement") which provides for a credit facility not to exceed \$2.0 million, subject to a borrowing base formula. The SVB Loan Agreement was amended on February 27, 2009 (the "SVB Loan Amendment"). Pursuant to the terms of the SVB Loan Amendment, among other things, SVB (i) decreased the interest rate on the revolving line of credit to the greater of 3.50% over the prime rate or 7.5% (from the greater of 3% over the prime rate or 10.5%), (ii) modified the tangible net worth covenant to no less than negative seventeen million dollars (\$17,000,000) at all times, increasing quarterly by fifty percent (50%) of net income and monthly by fifty percent (50%) of issuances of equity after January 31, 2009 and the principal amount of subordinated debt received after January 31, 2009, (iii) modified the borrowing base to seventy percent (70%) of eligible accounts and the lesser of sixty percent (60%) of advanced billing accounts or six hundred thousand dollars (\$600,000) as determined by SVB; provided, however, that SVB may, with notice to the Company, decrease the foregoing percentage in its good faith business judgment based on events, conditions, contingencies, or risks which, as determined by SVB, may adversely affect collateral, and (iv) extended the revolving line maturity date to May 15, 2010.

In March 2010, the SVB Loan Agreement was amended. Pursuant to the terms of the Loan Amendment, among other things, SVB (i) increased the revolving line balance to \$2.3 million (from \$2.0 million), (ii) decreased the interest rate on the revolving line of credit to 2.0% (from 3.5%) over the greater of the SVB prime rate or 6.0% (from 7.5%), (iii) modified the tangible net worth covenant to no less than negative eighteen million dollars (\$18,000,000) at all times, increasing quarterly by fifty percent (50%) of net income and monthly by fifty percent (50%) of issuances of equity after January 31, 2010 and the principal amount of subordinated debt received after January 31, 2010, (iv) modified the borrowing base to eighty percent (80%) of eligible accounts, and (v) extended the revolving line maturity date to May 15, 2011. At March 31, 2010, total availability under the SVB Loan Agreement was \$2.2 million, of which \$1.6 million was outstanding, with an applicable interest rate was 6.0%. The Company was in compliance with the above stated covenants and restrictions. The obligations under the SVB Loan Agreement are secured by substantially all of St. Bernard's assets.

In addition, the Loan Amendment provides for two additional term loan facilities totaling \$500,000 that can only be used to repay indebtedness owing from the Company to Partners for Growth. Term Loan A, in the amount of \$300,000, accrues interest at a floating per annum rate equal to the greater of two percentage points (2.00%) above the SVB prime rate or six percent (6.00%). Term Loan B, in the amount of \$200,000, accrues interest at a floating per annum rate equal to the greater of three and one half percentage points (3.50%) above the SVB prime rate or seven and one half percent (7.50%).

In connection with the execution of a previous SVB Loan Amendment dated January 25, 2008, St. Bernard issued warrants to SVB which allows SVB to purchase up to 140,350 shares of our common stock at an exercise price of \$0.57 per share. The warrants expire on the seventh anniversary of their issue date. We recorded deferred debt issuance costs in the amount of \$58,000, based on the estimated fair value allocated to the warrants using the following assumptions; 75.35% volatility, risk free interest rate of 3.61%, an expected life of seven years and no dividends. Amortization of the debt issuance costs, including amounts recorded as a debt discount for warrants previously issued, for the three months ended March 31, 2010 and 2009, which is being recorded as interest expense, was approximately \$0 and \$23,000, respectively. Furthermore, St. Bernard agreed to grant SVB certain piggyback registration rights with respect to the shares of common stock underlying the warrants.

#### Partners for Growth II, LP

On July 21, 2008, the Company entered into a Loan Agreement with PFG (the "PFG Loan Agreement"), which became effective on July 23, 2008 and which provides for a credit facility not to exceed \$1.5 million, subject to a borrowing base formula. The PFG Loan Agreement was subsequently amended on February 27, 2009. The annual interest rate on the PFG Loan is set at the Prime Rate, quoted by SVB as its Prime Rate, plus 3% (the "Applicable Rate"). At March 31, 2010, the effective interest rate was 7%. The PFG Loan Agreement will terminate on July 20, 2010, on which date all principal, interest and other outstanding monetary obligations must be repaid to PFG. The obligations under the PFG Loan Agreement are secured by a security interest in collateral comprised of substantially all of St. Bernard's assets, subordinated to the SVB Loan Agreement.

The PFG Loan Agreement contains affirmative, negative and financial covenants customary for credit facilities of this type, including, among other things, limitations on indebtedness, liens, sales of assets, mergers, investments, and dividends. The PFG Loan Agreement also requires that St. Bernard maintain a Modified Net Income (as defined in the PFG Loan Agreement) greater than zero. PFG eliminated the Modified Net Income covenant for the reporting periods ending February 28, 2009 and March 31, 2009. The PFG Loan Agreement contains events of default customary for credit facilities of this type (with customary grace or cure periods, as applicable) and provides that upon the occurrence and during the continuance of an event of default, among other things, the interest rate on all borrowings will be increased, the payment of all borrowings may be accelerated, PFG's commitments may be terminated and PFG shall be entitled to exercise all of its rights and remedies, including remedies against collateral. At March 31, 2010, the Company was in compliance with the above stated covenants.

In connection with the execution of the PFG Loan Agreement, St. Bernard received approximately \$1,000 from PFG, and as a result, issued a warrant to PFG on July 21, 2008 (the "Warrant"), which allows PFG to purchase up to 450,000 shares of St. Bernard common stock at an exercise price equal to \$0.46 per share. The Warrant expires on July 20, 2013. The Company recorded deferred debt issuance costs in the amount of \$125,000, based on the estimated fair value allocated to the warrants using the following assumptions; 69.07% volatility, risk free interest rate of 4.09%, an expected life of five years and no dividends. Amortization of the debt issuance costs for the three months ended March 31, 2010 and 2009, which is being recorded as interest expense, was approximately \$15,000 and \$16,000, respectively. As of March 31, 2010, total availability under the PFG Loan Agreement was \$1.5 million, of which \$750,000 was outstanding.

### Liquidity

As of March 31, 2010, the Company had approximately \$2.8 million in cash and cash equivalents and a working capital deficit of \$9.2 million. Approximately \$10.1 million of our current liability balance at March 31, 2010 consisted of deferred revenues, which represents amounts that are expected to be amortized into revenue as they are earned in future periods. For the three months ended March 31, 2010, the Company incurred a net loss of \$149,000, and through March 31, 2010 has recorded a cumulative net loss of \$49.8 million. For the three months ended March 31, 2010 cash provided by operating activities was \$273,000.

During March 2010, the Company and SVB entered into an amendment to the credit facility which, among other things, SVB (i) increased the revolving line balance to \$2.3 million (from \$2.0 million), (ii) decreased the interest rate on the revolving line of credit to 2.0% (from 3.5%) over the greater of the SVB prime rate or 6.0% (from 7.5%), (iii) modified the tangible net worth covenant to no less than negative eighteen million dollars (\$18,000,000) at all times, increasing quarterly by fifty percent (50%) of net income and monthly by fifty percent (50%) of issuances of equity after January 31, 2010 and the principal amount of subordinated debt received after January 31, 2010, (iv) modified the borrowing base to eighty percent (80%) of eligible accounts, and (v) extended the revolving line maturity date to May 15, 2011. In addition, the Loan Amendment provides for two additional term loan facilities totaling \$500,000 that can only be used to repay indebtedness owing from the Company to Partners for Growth. Term Loan A, in the amount of \$300,000, accrues interest at a floating per annum rate equal to the greater of two percentage points (2.00%) above the SVB prime rate or six percent (6.00%). Term Loan B, in the amount of \$200,000, accrues interest at a floating per annum rate equal to the greater of three and one half percentage points (3.50%) above the SVB prime rate or seven and one half percent (7.50%) (See Note 3).

The Company believes that its existing cash resources, combined with projected collections on billings, and borrowing availability under existing credit facilities, will provide sufficient liquidity for the Company to meet its continuing obligations for the next twelve months. However, there can be no assurances that projected collections will be achieved or the improvement in operating results or cash flows from operating activities will continue. In the event cash flow from operating activities and additional borrowings under existing credit facilities are not sufficient, the Company may require additional sources of financing in order to maintain its current operations. These additional sources of financing may include public or private offerings of equity or debt securities. In the current capital environment, no assurance can be given that additional sources of financing will be available on acceptable terms, on a timely basis, or at all.

### Off-Balance Sheet Arrangements

Except for the commitments arising from our operating lease arrangements, we have no other off-balance sheet arrangements that are reasonably likely to have a material effect on our financial statements.

### Forward-Looking Statements



This Quarterly Report on Form 10-Q and the information incorporated herein by reference contain forward-looking statements that involve a number of risks and uncertainties. Although our forward-looking statements reflect the good faith judgment of our management, these statements can only be based on facts and factors currently known by us. Consequently, these forward-looking statements are inherently subject to risks and uncertainties, and actual results and outcomes may differ materially from results and outcomes discussed in the forward-looking statements. For a summary of such risks and uncertainties, please see Risk Factors located in our Annual Report on Form 10-K for the year ended December 31, 2009 filed with the Securities and Exchange Commission on March 26, 2010.

Forward-looking statements can be identified by the use of forward-looking words such as “believes,” “expects,” “hopes,” “may,” “will,” “plan,” “intends,” “estimates,” “could,” “should,” “would,” “continue,” “seeks,” “pro forma,” or “anticipates,” or words (including their use in the negative), or by discussions of future matters such as the development of new products, technology enhancements, possible changes in legislation and other statements that are not historical.

The cautionary statements made in this report are intended to be applicable to all related forward-looking statements wherever they may appear in this report. We urge you not to place undue reliance on these forward-looking statements, which speak only as of the date of this report. Except as required by law, we assume no obligation to update our forward-looking statements, even if new information becomes available in the future.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk

As a Smaller Reporting Company as defined by Rule 12b-2 of the Exchange Act and in item 10(f)(1) of Regulation S-K, we are electing scaled disclosure reporting obligations and therefore are not required to provide the information requested by this Item.

#### Item 4T. Controls and Procedures

##### Evaluation of Disclosure Controls

We maintain "disclosure controls and procedures," as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognizes that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, our management was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures is also based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Based on his evaluation as of the end of the period covered by this Quarterly Report on Form 10-Q and subject to the foregoing, our Chief Executive Officer has concluded that our disclosure controls and procedures were effective.

##### Changes in Internal Control over Financial Reporting

During the period covered by this report, there were no changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II – OTHER INFORMATION

#### Item 1. Legal Proceedings

In the normal course of business, the Company is occasionally named as a defendant in various lawsuits. On July 9, 2009, an action was filed in the United States District Court for the Southern District of California by Southwest Technology Innovations LLC (the "Plaintiff") against the Company and Espion International, Inc., Workgroup Solutions, Inc., SonicWall, Inc., Mirapoint Software, Inc., and Proofpoint, Inc., (collectively the "Defendants"). In this matter, the Plaintiff's claim against the Company is that the ePrism e-mail filter products, which are manufactured by an unrelated third party and sold by the Company, allegedly infringe upon U.S. Patent No. 6,952,719 entitled "Spam Detector Defeating System" which was issued on October 4, 2005. The Plaintiff is seeking a judgment in Plaintiff's favor, injunctive relief, and an award of unspecified damages. The Company is vigorously defending its interests in this matter.

#### Item 1A. Risk Factors

As a Smaller Reporting Company as defined by Rule 12b-2 of the Exchange Act and in item 10(f)(1) of Regulation S-K, we are electing scaled disclosure reporting obligations and therefore are not required to provide the information requested by this Item.

#### Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. [Reserved]

Item 5. Other Information

None.

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Item 6. Exhibits

- 3.1 Amended and Restated Certificate of Incorporation of St. Bernard Software, Inc. (formerly known as Sand Hill IT Security Acquisition Corp.) (incorporated herein by reference to Exhibit 3.1.1 to the Company's Registration Statement on Form S-4 initially filed with the Securities and Exchange Commission on December 16, 2005).
- 3.2 Amended and Restated Bylaws of St. Bernard Software, Inc. (formerly known as Sand Hill IT Security Acquisition Corp.) (incorporated herein by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K initially filed with the Securities and Exchange Commission on April 5, 2007).
- 4.1 Specimen Unit Certificate of St. Bernard Software, Inc. (formerly known as Sand Hill IT Security Acquisition Corp.) (incorporated herein by reference to Exhibit 4.1 to the Company's Amendment No. 2 to the Registration Statement on Form S-1 (File No. 333-114861) filed with the Securities and Exchange Commission on June 23, 2004).
- 4.2 Specimen Common Stock Certificate of St. Bernard Software, Inc. (formerly known as Sand Hill IT Security Acquisition Corp.) (incorporated herein by reference to Exhibit 4.2 to the Company's Amendment No. 2 to the Registration Statement on Form S-1 (File No. 333-114861) filed with the Securities and Exchange Commission on June 23, 2004).
- 4.3 Specimen Warrant Certificate of St. Bernard Software, Inc. (formerly known as Sand Hill IT Security Acquisition Corp.) (incorporated herein by reference to Exhibit 4.3 to the Company's Amendment No. 2 to the Registration Statement on Form S-1 (File No. 333-114861) filed with the Securities and Exchange Commission on June 23, 2004).
- 4.4 Unit Purchase Option No. UPO-2 dated July 30, 2004, granted to Newbridge Securities Corporation (incorporated herein by reference to Exhibit 4.4.1 to the Company's Annual Report on Form 10-KSB filed with the Securities and Exchange Commission on March 31, 2005).
- 4.5 Unit Purchase Option No. UPO-3 dated July 30, 2004, granted to James E. Hosch (incorporated herein by reference to Exhibit 4.4.2 to the Company's Annual Report on Form 10-KSB filed with the Securities and Exchange Commission on March 31, 2005).
- 4.6 Unit Purchase Option No. UPO-4 dated July 30, 2004, granted to Maxim Group, LLC (incorporated herein by reference to Exhibit 4.4.3 to the Company's Annual Report on Form 10-KSB filed with the Securities and Exchange Commission on March 31, 2005).
- 4.7 Unit Purchase Option No. UPO-5 dated July 30, 2004, granted to Broadband Capital Management, LLC (incorporated herein by reference to Exhibit 4.4.4 to the Company's Annual Report on Form 10-KSB filed with the Securities and Exchange Commission on March 31, 2005).
- 4.8 Unit Purchase Option No. UPO-6 dated July 30, 2004, granted to I-Bankers Securities Incorporated (incorporated herein by reference to Exhibit 4.4.5 to the Company's Annual Report on Form 10-KSB filed with the Securities and Exchange Commission on March 31, 2005).
- 4.9

Warrant issued by St. Bernard Software, Inc. on May 16, 2007 to Silicon Valley Bank (incorporated herein by reference to Exhibit 4.1 to the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on May 23, 2007).

- 4.10 Warrant issued by St. Bernard Software, Inc. on January 25, 2008 to Agility Capital, LLC (incorporated herein by reference to Exhibit 4.1 to the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on January 31, 2008).
- 4.11 Warrant issued by St. Bernard Software, Inc. on January 25, 2008 to Silicon Valley Bank (incorporated herein by reference to Exhibit 4.2 to the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on January 31, 2008).
- 4.12 Warrant issued by St. Bernard Software, Inc. on July 21, 2008 to Partners for Growth II, L.P. (incorporated herein by reference to Exhibit 4.1 to the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on July 28, 2008).
- 4.13 Warrant Purchase Agreement between St. Bernard Software, Inc. and Partners for Growth II, L.P. dated July 21, 2008 (incorporated herein by reference to Exhibit 4.2 to the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on July 28, 2008).
- 4.14 Warrant Purchase Agreement among Humphrey P. Polanen and Newbridge Securities Corporation and I-Bankers Securities Incorporated (incorporated herein by reference to Exhibit 10.13 to the Company's Registration Statement on Form S-1 (File No. 333-114861) filed with the Securities and Exchange Commission on April 26, 2004.)
- 10.1 St. Bernard Software, Inc. Amended and Restated 2005 Stock Option Plan (incorporated herein by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on January 4, 2008).
- 10.2 St. Bernard Software, Inc. 2006 Employee Stock Purchase Plan (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on December 22, 2006).
- 10.3 St. Bernard Software, Inc. 2006 Recruitment Equity Incentive Plan (incorporated herein by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on December 22, 2006).

- 10.4 Loan and Security Agreement between St. Bernard Software, Inc. and Silicon Valley Bank dated May 11, 2007 (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on May 23, 2007).
- 10.5 Third Amendment to Loan and Security Agreement between St. Bernard Software, Inc. and Silicon Valley Bank dated January 25, 2008 (incorporated herein by reference to Exhibit 10.4 to the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on January 31, 2008).
- 10.6 Intellectual Property Security Agreement between St. Bernard Software, Inc. and Silicon Valley Bank dated January 25, 2008 (incorporated herein by reference to Exhibit 10.5 to the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on January 31, 2008).
- 10.7\* Employment Agreement between St. Bernard Software, Inc. and Louis E. Ryan executed February 10, 2009 (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on February 11, 2009).
- 10.8 Fifth Amendment to Loan and Security Agreement between St. Bernard Software, Inc. and Silicon Valley Bank dated February 27, 2009 (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on March 6, 2009).
- 10.9 First Amendment to Loan Agreement between St. Bernard Software, Inc. and Partners for Growth II, L.P. dated February 27, 2009 (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on March 6, 2009).
- 10.10\* Amended Employment Agreement between St. Bernard Software, Inc. and Steve Yin executed April 2, 2009 (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on April 7, 2009).
- 10.11\* Employment agreement between St. Bernard Software, Inc. and Thalia Gietzen executed June 15, 2009 (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on July 13, 2009).
- 10.12\* Amended Employment Agreement between St. Bernard Software, Inc. and Louis E. Ryan executed January 19, 2010 (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on January 25, 2010).
- 10.13 Sixth Amendment to Loan and Security Agreement between St. Bernard Software, Inc. and Silicon Valley Bank dated March 23, 2010 (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on March 25, 2010).

Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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\* Management contract or compensatory plan or arrangement

SIGNATURES

In accordance with Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ST. BERNARD SOFTWARE, INC.

Dated: May 7, 2010

By:

/s/ Louis E. Ryan  
Louis E. Ryan  
Chief Executive Officer and  
Chairman of the Board of  
Directors



