

ST. BERNARD SOFTWARE, INC.
Form 10-Q
November 15, 2010

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 September 30, 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

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 15,922,696 shares of its common stock, par value \$0.01 per share, outstanding at November 15, 2010.

ST. BERNARD SOFTWARE, INC.

INDEX TO FORM 10-Q

| | Page |
|---|------|
| PART I – FINANCIAL INFORMATION | |
| ITEM 1. | 1 |
| FINANCIAL STATEMENTS | |
| | 1 |
| CONDENSED CONSOLIDATED BALANCE SHEETS AS OF SEPTEMBER 30, 2010 (UNAUDITED) AND DECEMBER 31, 2009 | |
| | 2 |
| CONDENSED CONSOLIDATED STATEMENTS OF INCOME FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2010 AND SEPTEMBER 30, 2009 (UNAUDITED) | |
| | 3 |
| CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' DEFICIT FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2010 (UNAUDITED) | |
| | 4 |
| CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2010 AND SEPTEMBER 30, 2009 (UNAUDITED) | |
| | 5 |
| NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS | |
| ITEM 2. | 14 |
| MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS | |
| ITEM 3. | 22 |
| QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK | |
| ITEM 4T. | 23 |
| CONTROLS AND PROCEDURES | |
| PART II – OTHER INFORMATION | |
| ITEM 1. | 23 |
| LEGAL PROCEEDINGS | |
| ITEM 1A. | 24 |
| RISK FACTORS | |
| ITEM 2. | 24 |
| UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS | |
| ITEM 3. | 24 |
| DEFAULTS UPON SENIOR SECURITIES | |
| ITEM 4. | 24 |
| [REMOVED AND RESERVED] | |

| | | |
|---------|-------------------|----|
| ITEM 5. | OTHER INFORMATION | 24 |
| ITEM 6. | EXHIBITS | 25 |

PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

St. Bernard Software, Inc.

Condensed Consolidated Balance Sheets

| | September 30, 2010 (Unaudited) | December 31, 2009 |
|---|-----------------------------------|----------------------|
| Assets | | |
| Current Assets | | |
| Cash and cash equivalents | \$ 2,789,000 | \$ 2,454,000 |
| Accounts receivable - net of allowance for doubtful accounts of \$30,000 and \$13,000 at September 30, 2010 and December 31, 2009, respectively | 4,446,000 | 2,534,000 |
| Inventories - net | 447,000 | 242,000 |
| Prepaid expenses and other current assets | 409,000 | 335,000 |
| Total current assets | 8,091,000 | 5,565,000 |
| Fixed Assets - Net | 588,000 | 564,000 |
| Goodwill | 8,280,000 | 7,568,000 |
| Intangible Assets - Net | 619,000 | - |
| Other Assets | 737,000 | 148,000 |
| Total Assets | \$ 18,315,000 | \$ 13,845,000 |
| Liabilities and Stockholders' Deficit | | |
| Current Liabilities | | |
| Short-term borrowings | \$ 483,000 | \$ 2,250,000 |
| Accounts payable | 981,000 | 817,000 |
| Accrued compensation | 1,349,000 | 834,000 |
| Accrued expenses and other current liabilities | 819,000 | 597,000 |
| Warranty liability | 190,000 | 192,000 |
| Capitalized lease obligations | - | 22,000 |
| Deferred revenue | 10,942,000 | 10,209,000 |
| Total current liabilities | 14,764,000 | 14,921,000 |
| Convertible Note Payable | 3,175,000 | - |

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| | | |
|---|---------------|---------------|
| Deferred Revenue | 10,054,000 | 7,708,000 |
| Total liabilities | 27,993,000 | 22,629,000 |
| 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; 15,922,696 and 13,319,991 shares issued and outstanding at September 30, 2010 and December 31, 2009, respectively | 157,000 | 132,000 |
| Additional paid-in capital | 41,742,000 | 40,774,000 |
| Accumulated deficit | (51,577,000) | (49,690,000) |
| Total stockholders' deficit | (9,678,000) | (8,784,000) |
| Total Liabilities and Stockholders' Deficit | \$ 18,315,000 | \$ 13,845,000 |

See accompanying notes

St. Bernard Software, Inc.

Condensed Consolidated Statements of Operations (Unaudited)

| | Three months ended September 30, | | Nine months ended September 30, | |
|--|----------------------------------|--------------|---------------------------------|---------------|
| | 2010 | 2009 | 2010 | 2009 |
| Revenues | | | | |
| Subscription | \$ 3,623,000 | \$ 3,615,000 | \$ 10,534,000 | \$ 10,996,000 |
| Appliance | 961,000 | 875,000 | 2,727,000 | 2,691,000 |
| License | 3,000 | 3,000 | 56,000 | 9,000 |
| Total Revenues | 4,587,000 | 4,493,000 | 13,317,000 | 13,696,000 |
| Cost of Revenues | | | | |
| Subscription | 678,000 | 416,000 | 1,488,000 | 1,316,000 |
| Appliance | 651,000 | 594,000 | 1,884,000 | 1,826,000 |
| License | 1,000 | 9,000 | 13,000 | 11,000 |
| Total Cost of Revenues | 1,330,000 | 1,019,000 | 3,385,000 | 3,153,000 |
| Gross Profit | 3,257,000 | 3,474,000 | 9,932,000 | 10,543,000 |
| Operating Expenses | | | | |
| Sales and marketing | 1,868,000 | 1,474,000 | 5,288,000 | 4,715,000 |
| Research and development | 1,249,000 | 860,000 | 2,964,000 | 2,988,000 |
| General and administrative | 1,330,000 | 462,000 | 3,335,000 | 2,709,000 |
| Impairment expense | - | 473,000 | - | 473,000 |
| Total Operating Expenses | 4,447,000 | 3,269,000 | 11,587,000 | 10,885,000 |
| (Loss) Income from Operations | (1,190,000) | 205,000 | (1,655,000) | (342,000) |
| Other Expense (Income) | | | | |
| Interest expense - net | 37,000 | 79,000 | 133,000 | 250,000 |
| Other expense (income) | 79,000 | 9,000 | 99,000 | (29,000) |
| Total Other Expense | 116,000 | 88,000 | 232,000 | 221,000 |
| Loss (Income) Before Income Taxes | (1,306,000) | 117,000 | (1,887,000) | (563,000) |
| Income tax expense | - | - | - | (5,000) |
| Net (Loss) Income | \$ (1,306,000) | \$ 117,000 | \$ (1,887,000) | \$ (568,000) |
| (Loss) Income Per Common Share - Basic | \$ (0.09) | \$ 0.01 | \$ (0.14) | \$ (0.04) |
| (Loss) Income Per Common Share - Diluted | \$ (0.09) | \$ 0.01 | \$ (0.14) | \$ (0.04) |
| Weighted Average Shares | | | | |
| Outstanding - Basic | 15,069,595 | 13,720,371 | 13,956,331 | 14,467,141 |
| Outstanding - Diluted | 15,069,595 | 13,873,815 | 13,956,331 | 14,467,141 |

See accompanying notes

2

Condensed Consolidated Statement of Stockholders' Deficit (Unaudited)

| | Common Stock Shares | Common Stock Amount | Additional Paid-in Capital | Accumulated Deficit | Total |
|--|------------------------|------------------------|----------------------------------|------------------------|---------------|
| 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 | 139,886 | 1,000 | 24,000 | - | 25,000 |
| Common stock issued for the exercise of employee stock options | 46,547 | - | 12,000 | - | 12,000 |
| Common stock issued in connection with asset purchase agreement | 2,416,272 | 24,000 | 797,000 | - | 821,000 |
| Stock-based compensation expense | - | - | 135,000 | - | 135,000 |
| Net loss | - | - | - | (1,887,000) | (1,887,000) |
| Balance at September 30, 2010 | 15,922,696 | \$ 157,000 | \$41,742,000 | \$(51,577,000) | \$(9,678,000) |

See accompanying notes

St. Bernard Software, Inc.

Condensed Consolidated Statements of Cash Flows (Unaudited)

| | Nine months ended September 30, | |
|---|------------------------------------|--------------|
| | 2010 | 2009 |
| Cash Flows From Operating Activities | | |
| Net loss | \$(1,887,000) | \$(568,000) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization | 314,000 | 281,000 |
| Allowance for doubtful accounts | (9,000) | (32,000) |
| Loss on change in fair value of warrant derivative liability | 102,000 | 8,000 |
| Write-off of capitalized software | - | 473,000 |
| Stock-based compensation expense | 135,000 | 486,000 |
| Noncash interest expense | 48,000 | 116,000 |
| Change in operating assets and liabilities, net of effect of acquisition: | | |
| Accounts receivable | (1,265,000) | 495,000 |
| Inventories | (156,000) | (10,000) |
| Prepaid expenses and other assets | (650,000) | (418,000) |
| Accounts payable | (256,000) | (376,000) |
| Accrued expenses and other current liabilities | 47,000 | (1,165,000) |
| Accrued compensation | 515,000 | 543,000 |
| Warranty liability | (2,000) | - |
| Deferred revenue | 2,102,000 | 67,000 |
| Net cash used by operating activities | (962,000) | (100,000) |
| Cash Flows From Investing Activities | | |
| Acquisition, net of cash acquired | (66,000) | - |
| Purchases of fixed assets | (59,000) | (75,000) |
| Net cash used by investing activities | (125,000) | (75,000) |
| Cash Flows From Financing Activities | | |
| Proceeds from convertible note payable | 3,175,000 | - |
| Proceeds from stock option exercises | 12,000 | - |
| Proceeds from the sales of stock under the employee stock purchase plan | 24,000 | 24,000 |
| Principal payments on capitalized lease obligations | (22,000) | (117,000) |
| Net decrease in short-term borrowings | (1,767,000) | (362,000) |
| Net cash provided (used) by financing activities | 1,422,000 | (455,000) |
| Net Increase (Decrease) in Cash and Cash Equivalents | 335,000 | (630,000) |
| Cash and Cash Equivalents at Beginning of Period | 2,454,000 | 2,051,000 |
| Cash and Cash Equivalents at End of Period | \$2,789,000 | \$1,421,000 |
| Supplemental Disclosures of Cash Flow Information: | | |
| Cash paid during the period for: | | |
| Interest | \$69,000 | \$101,000 |
| Income taxes | \$2,000 | \$3,000 |

Non Cash Investing and Financing Activities:

The Company acquired substantially all of the assets of Red Condor, Inc. for consideration of \$1.0 million.

| | |
|-----------------------------------|-------------|
| Fair value of assets acquired | \$2,492,000 |
| Purchase consideration: | |
| Common stock | (821,000) |
| Cash | (220,000) |
| Fair Value of liabilities assumed | \$1,451,000 |

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

St. Bernard Software, Inc.

Notes to Condensed Consolidated Financial Statements

1. Basis of Presentation and Summary of Significant Accounting Policies

St. Bernard Software, Inc., a Delaware corporation (“we,” “us,” “our,” the “Company,” or “St. Bernard”) designs, develops, and markets on-demand, on-premises and hybrid Secure Content Management (“SCM”) solutions to the mid enterprise and Managed Service Provider (“MSP”) markets. Our solutions help IT professionals effectively manage their enterprise’s web and messaging security needs thru a differentiated, modular offering. Our Cloud Service Platform enables customers and MSP providers alike to easily provision the SCM solutions they need into an array of flexible deployment options. Our on-demand approach enables flexibility, scalability and reliability that optimizes Total Cost of Ownership (“TCO”) and Total Cost of Acquisition (“TCA”) around our customers’ budgetary needs. With an extensive ISP/MSP partner network, thousands of enterprises and millions of end users worldwide, St. Bernard is rapidly expanding its solution set into a larger, global footprint.

Customers can purchase our solutions directly from us, through a managed service provider, or via one of our Pro Partners around the world. On-premises purchases typically consist of an initial hardware purchase (appliance) and maintenance subscription, whereas our on-demand purchases contain only a subscription. Our primary customers are IT executives, managers and administrators as well as Managed Service Providers (“MSP’s”) and Internet Service Providers (“ISP’s”).

Basis of presentation

The condensed consolidated financial statements included in this report are unaudited and have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and 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 condensed 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 condensed 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.

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 September 30, 2010, the Company had approximately \$2.8 million in cash and cash equivalents and a working capital deficit of \$6.7 million. Approximately \$10.9 million of the Company’s current liability balance at September 30, 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 nine months ended September 30, 2010, the Company incurred a net loss of \$1.9 million, and through September 30, 2010 has recorded a cumulative net loss of \$51.6 million. For the nine months ended September 30, 2010 net cash used by operating activities was \$962,000.

As described at Note 4 to the accompanying financial statements, the Company has existing credit facilities with Silicon Valley Bank (“SVB”), under which there is borrowing availability of \$1.9 million as of September 30, 2010. On July 20, 2010, a \$750,000 note from Partner for Growth (“PFG”) was paid off and during the three months ended September 30, 2010, the Company received proceeds of \$3.2 million in connection with the issuance of subordinated convertible notes.

St. Bernard Software, Inc.

Notes to Condensed Consolidated Financial Statements

The Company believes that its existing cash resources as of September 30, 2010, combined with proceeds from the issuance of convertible notes in July 2010, projected collections on billings, and borrowing availability under existing SVB 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.

Identified intangible assets

Identified intangible assets primarily consist of technology and intellectual property acquired pursuant to the asset purchase agreement between the Company and Red Condor, Inc., which are generally amortized on a straight-line basis over five years. The Company performs a quarterly review of identified intangible assets to determine if facts and circumstances indicate that the useful life is shorter than it had originally estimated or if there are any indicators of impairment. If indicators of impairment are present, the Company assesses the recoverability of identified intangible assets by comparing the projected undiscounted net cash flows associated with the related assets over their remaining lives against their respective carrying amounts. Impairments, if any, are based on the excess of the carrying amount over the fair value of those assets. If the useful life is shorter than originally estimated, the Company accelerates the rate of amortization and amortizes the remaining carrying value over the new shorter useful life. There were no impairment charges related to identified intangible assets during the three and nine months ended September 30, 2010.

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 3 and 5). 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 the three and nine months ended September 30, 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.

New accounting standards

In October 2009, the Financial Accounting Standards Boards ("FASB") issued Accounting Standards Update ("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.

St. Bernard Software, Inc.

Notes to Condensed 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. Business Combination

Asset purchase agreement

On July 28, 2010, the Company entered into an Asset Purchase Agreement ("APA") with Red Condor, Inc., a private Delaware corporation, based in Rohnert Park, CA ("Red Condor") and certain note holders (the "Noteholders") of Red Condor, pursuant to which St. Bernard purchased substantially all of the assets and assumed certain liabilities of Red Condor in exchange for restricted shares of Common Stock of St. Bernard, subject to certain post-closing adjustments described in the APA (the "Transaction"). The assumed liabilities included approximately: (i) \$420,000 in accounts payable and (ii) \$42,000 of accrued vacation time. Included in the acquired assets was approximately \$638,000 in Red Condor accounts receivable.

The Transaction closed on August 2, 2010 (the "Closing Date"). On the Closing Date, and in consideration for the Transaction, St. Bernard issued to the Noteholders of Red Condor, 2,416,272 restricted shares of Common Stock (the "Purchase Shares"), of which 483,254 shares of Common Stock, are being held in Escrow for 18 months. In addition, in connection with the Transaction, the Company agreed to forgive the repayment of a previous advance to Red Condor in the aggregate amount of \$220,000.

Under the APA, St. Bernard agreed to offer employment to 34 employees of Red Condor, and agreed to continue relationships with certain independent contractors after the closing date.

Goodwill associated with the acquisition of Red Condor and pro forma financials

The acquisition of Red Condor's assets has been accounted for using the purchase method of accounting and, accordingly, the tangible and intangible assets acquired and liabilities assumed from Red Condor were recorded at their estimated fair values as of the date of the acquisition. The total purchase consideration paid by the Company was approximately \$1,041,000. The initial purchase price allocation shown below is preliminary. Changes to amounts recorded as assets and liabilities may result in a corresponding adjustment of goodwill.

7

St. Bernard Software, Inc.

Notes to Condensed Consolidated Financial Statements

| | Amount |
|-------------------------------------|---------------|
| Net tangible assets and liabilities | \$ (310,000) |
| Goodwill | 711,000 |
| Intangible assets | 640,000 |
| | \$ 1,041,000 |

The amount allocated to the intangible assets represents the Company's preliminary estimate of the identifiable intangible assets acquired from Red Condor, consisting of the Red Condor technology and intellectual property.

After making every reasonable effort to provide the pro forma consolidated information that summarizes the combined results of operations for the Company and Red Condor for the three and nine months ended September 30, 2010 and 2009, the Management of the Company has determined that it is impracticable to provide as the Red Condor, Inc. information is not readily available on a interim period basis.

3. Stock-Based Compensation Expense

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. As of September 30, 2010, the Company had 3,938,709 option shares outstanding and 679,478 options shares available for issuance under the Plans.

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 nine months ended September 30, 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.

St. Bernard Software, Inc.

Notes to Condensed Consolidated Financial Statements

| | Nine Months Ended September 30, 2010 | Nine Months Ended September 30, 2009 |
|---------------------------------|---|---|
| Average expected life (years) | 6.5 | 6.5 |
| Average expected volatility | 49.5% | 50.6% |
| Average risk-free interest rate | 3.4% | 3.6% |
| Average expected dividend yield | 0 | 0 |

Total stock-based compensation expense (income) was approximately \$52,000 and (\$183,000) for the three months ended September 30, 2010 and 2009, respectively, and \$135,000 and \$486,000 for the nine months ended September 30, 2010 and 2009, respectively. The decrease in stock-based compensation expense was mainly due to the expense relating to the vesting of options during the 2009 period for a former executive officer of the Company. The stock-based compensation expenses were charged to operating expenses. The effect on income (loss) per share as a result of the stock based compensation income (expense) was approximately \$0.00 and \$0.01 for the three months ended September 30, 2010 and 2009, respectively, and \$0.01 and (\$0.03) for the nine months ended September 30, 2010 and 2009, respectively. The tax effect was immaterial.

The following is a summary of stock option activity for the nine months ended September 30, 2010:

| | Number of Shares Outstanding | Weighted Average Exercise Price |
|---|------------------------------------|--|
| Options outstanding at December 31, 2009 | 2,455,049 | \$ 0.22 |
| Granted | 1,678,000 | \$ 0.32 |
| Exercised | (46,547) | \$ 0.25 |
| Forfeited | (147,793) | \$ 0.25 |
| Options outstanding at September 30, 2010 | 3,938,709 | \$ 0.26 |
| Options exercisable at September 30, 2010 | 1,318,977 | \$ 0.24 |

Additional information regarding options outstanding as of September 30, 2010 is as follows:

| Range of 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 - \$ 0.16 | 481,750 | 8.46 | \$ 0.16 | 90,594 | \$ 0.15 |
| \$ 0.18 - \$ 0.19 | 41,000 | 8.25 | \$ 0.18 | 2,766 | \$ 0.19 |
| \$ 0.20 - \$ 0.20 | 395,000 | 8.94 | \$ 0.20 | 104,323 | \$ 0.20 |
| \$ 0.22 - \$ 0.24 | 338,000 | 9.16 | \$ 0.23 | 42,222 | \$ 0.23 |
| \$ 0.25 - \$ 0.25 | 1,264,459 | 5.22 | \$ 0.25 | 1,077,092 | \$ 0.25 |
| \$ 0.26 - \$ 0.26 | 6,000 | 8.98 | \$ 0.26 | 1,980 | \$ 0.26 |

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| | | | | | | |
|---------|---------|-----------|------|---------|-----------|---------|
| \$ 0.29 | \$ 0.29 | 500,000 | 9.58 | \$ 0.29 | — | \$ — |
| \$ 0.32 | \$ 0.34 | 110,000 | 5.40 | \$ 0.34 | — | \$ — |
| \$ 0.35 | \$ 0.35 | 723,500 | 9.56 | \$ 0.35 | — | \$ — |
| \$ 0.42 | \$ 0.58 | 79,000 | 9.68 | \$ 0.53 | — | \$ — |
| \$ 0.14 | \$ 0.58 | 3,938,709 | 7.81 | \$ 0.26 | 1,318,977 | \$ 0.24 |

St. Bernard Software, Inc.

Notes to Condensed Consolidated Financial Statements

The aggregate intrinsic value of options outstanding and options exercisable at September 30, 2010 was approximately \$1.2 million and \$451,000, respectively. The aggregate intrinsic value represents the total intrinsic value based upon the stock price of \$0.58 at September 29, 2010. The aggregate intrinsic value of options outstanding and options exercisable at September 30, 2009 was approximately \$53,000 and \$12,000, respectively.

As of September 30, 2010, there was approximately \$266,000 of total unrecognized compensation expense related to unvested share-based compensation arrangements granted under the option plans. This cost is expected to be recognized over a weighted average period of 2.68 years.

4. Credit Facilities

On May 15, 2007, the Company entered into a Loan and Security Agreement with SVB (the "SVB Loan Agreement"). The SVB Loan Agreement was amended on February 27, 2009, March 23, 2010, and on September 29, 2010. 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) increased the Cash Sublimit, FX (foreign exchange) Sublimit and the Letter of Credit Sublimit from \$250,000 to \$650,000, (iii) 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%), (iv) 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 September 30, 2010 and the principal amount of subordinated debt received after September 30, 2010, (v) modified the borrowing base to eighty percent (80%) of eligible accounts, and (vi) extended the revolving line maturity date to May 15, 2011. At September 30, 2010, total availability under the SVB Loan Agreement was \$1.9 million, of which \$0 was outstanding with an applicable interest rate of 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 was used to repay indebtedness owing from the Company to Partners for Growth ("PFG") during July 2010. Term Loan A, which has a maturity date of May 15, 2011, 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, which has a maturity date of July 20, 2012, 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%). At September 30, 2010, the total amount outstanding under Term Loan A and Term Loan B were \$300,000 and \$183,000, respectively. The interest expense for Term Loans A and B for the three months and nine months ended September 30, 2010 was approximately \$6,000.

5. Convertible Notes

On August 2, 2010, St. Bernard issued convertible notes (the "Notes") in the amount of \$3.2 million pursuant to a Securities Purchase Agreement ("SPA") with certain Noteholders (the "Investors"). Pursuant to the terms of the SPA, St. Bernard has issued to the Investors Notes and Warrants ("Warrants") to purchase up to 210,111 shares of Common Stock in the aggregate. Under the terms of the Notes, the Notes mature on August 2, 2014. Interest on the outstanding principal balance accrues at a rate of three percent (3.0%) per annum and accrued interest is added to the balance of the Notes. All unpaid principal and interest on the Notes is due and payable at maturity. The Investors may convert the Notes at any time into shares of Common Stock of St. Bernard at a fixed conversion price of \$1.10. At any time after the issuance date of the Notes and prior to the Maturity Date, following the occurrence of any period of 60

consecutive trading days where the average closing price of the Common Stock of St. Bernard for such period is equal to or greater than \$1.25 per share, the entire unpaid principal amount of the Notes together with any unpaid interest shall be converted into Common Stock of St. Bernard at a conversion price of \$1.10. The Warrants have an exercise price equal to \$1.10 per share, are immediately exercisable and expire on August 2, 2014.

St. Bernard Software, Inc.

Notes to Condensed Consolidated Financial Statements

6. Warrants

As of September 30, 2010 and December 31, 2009, a total of 1,363,961 and 1,153,850 shares of common stock were outstanding, respectively, and were reserved for issuance for the exercise of warrants at exercise prices ranging from \$0.46 to \$1.60 per share. There were 210,111 warrants granted and none exercised or cancelled during the nine months ended September 30, 2010 (See Note 5).

7. Warrant Derivative Liability

At September 30, 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 September 30, 2010 the estimated fair value of the warrants, which is included in accrued expenses and other current liabilities in the accompanying condensed consolidated balance sheet, was determined based on a Black-Scholes option pricing model, to be \$121,000 (See Note 8). The changes in the estimated fair value of the warrant derivative liability for the three and nine months ended September 30, 2010 of \$82,000 and \$102,000 is included in other expense in the accompanying statement of operations.

8. 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.

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 September 30, 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 \$121,000. The warrants are valued using the Black-Scholes option pricing model using the valuation assumptions in the table below.

St. Bernard Software, Inc.

Notes to Condensed Consolidated Financial Statements

| | Nine months Ended September 30, 2010 |
|-------------------------|---|
| Remaining life (years) | 4.3 |
| Expected volatility | 53.4% |
| Risk-free interest rate | 2.5% |
| Expected dividend yield | 0 |
| Stock price | \$ 0.58 |

The following table reconciles the warrant derivative liability measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the nine months ended September 30, 2010:

| | |
|--|------------|
| Balance at December 31, 2009 | \$ 19,000 |
| Loss on change in fair value included in other expense | 102,000 |
| Balance at September 30, 2010 | \$ 121,000 |

Other financial instruments

The Company's other financial instruments consist of cash and cash equivalents, accounts receivable, accounts payable, accrued expenses, credit facility agreements, and capital lease agreements. 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.

9. Litigation

In the normal course of business, the Company is occasionally named as a defendant in various lawsuits. On September 7, 2010, an action was filed in the United States District Court Eastern District of Texas by Wordcheck Tech, LLC (the "Plaintiff") against the Company as well as ALT-N TECHNOLOGIES, LTD.; APPRIVER LLC; ATHENA ARCHIVER, INC.; AWARENESS TECHNOLOGIES, INC.; AXS- ONE, INC.; BITDEFENDER LLC; BLUE COAT SYSTEMS, INC.; CA, INC. D/B/A CA TECHNOLOGIES; CHECK POINT SOFTWARE TECHNOLOGIES, INC.; CHECK POINT SOFTWARE, LLC; CODE GREEN NETWORKS INTERNATIONAL, INC. ; CODE GREEN NETWORKS, INC.; COMPUTER ASSOCIATES INTERNATIONAL, INC.; COMPUTER MAIL SERVICES, INC.; ELECTRIC MAIL (INTERNATIONAL) L.P.; EMC CORPORATION; ENTRUST, INC. D/B/A ENTRUST TECHNOLOGIES, INC.; ESOFT, INC.; FACETIME COMMUNICATIONS, INC.; FIDELIS SECURITY SYSTEMS, INC.; FORTINET, INC.; GFI SOFTWARE DEVELOPMENT, LTD.; GFI USA, INC.; GLOBAL RELAY COMMUNICATIONS, INC.; GLOBAL RELAY USA, INC.; GTB TECHNOLOGIES, INC.; INTEGO, INC.; IRON MOUNTAIN INC. D/B/A IRON MOUNTAIN COMPANY; ITECH, INC.; J2 GLOBAL COMMUNICATIONS, INC.; LIVEOFFICE HOLDINGS, LLC; LIVEOFFICE, LLC; MICROWORLD TECHNOLOGIES, INC.; MIMICAST NORTH AMERICA, INC.; MIMICAST SERVICES LTD.; MIMICAST, LTD.; MIMOSA SYSTEMS, INC.; PALISADE SYSTEMS, INC.; PERMESSA CORPORATION; QUEST SOFTWARE, INC.; RED EARTH SOFTWARE (UK) LTD.; RED EARTH SOFTWARE, INC.; ROCKLIFFE

SYSTEMS D/B/A ROCKLIFFE SYSTEMS, INC. D/B/A ROCKLIFFE, INC. D/B/A MAILSITE, INC.; RSA SECURITY, INC.; RSA SECURITY, LLC; SAFENET, INC.; SHERPA SOFTWARE GROUP, INC. D/B/A SHERPA SOFTWARE; SHERPA SOFTWARE GROUP, L.P. A/K/A SHERPA SOFTWARE PARTNERS, L.P. D/B/A SHERPA SOFTWARE; SMARSH, INC.; SOLINUS, INC., D/B/A MAILFOUNDRY; THE ELECTRIC MAIL COMPANY; TRUSTWAVE CORPORATION; TRUSTWAVE HOLDINGS, INC.; UNIFY CORPORATION; VERDASYS INC.; VERICEPT CORPORATION; VIRTUALCONNECT TECHNOLOGIES, INC.; WATCHGUARD TECHNOLOGIES, INC.; WATERFORD TECHNOLOGIES GROUP, LTD. D/B/A WATERFORD TECHNOLOGIES GROUP; WATERFORD TECHNOLOGIES, INC. D/B/A SEATTLELAB, INC. D/B/A SEATTLELAB; WORKSHARE TECHNOLOGY, INC. D/B/A WORKSHARE, INC.; ZL TECHNOLOGIES, INC.; and ZSCALER, 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. 6,782,510 entitled “Word Checking Tool For Controlling The Language Content In Documents Using Dictionaries With Modifyable Status Fields” which was issued on August 24, 2004. The Plaintiff is seeking a judgment in favor of Plaintiff, including a permanent injunction, and is seeking an award of unspecified damages. The Company intends to vigorously defend its interests in this matter.

St. Bernard Software, Inc.

Notes to Condensed Consolidated Financial Statements

10. Commitment and Contingencies

Lease Agreement

On August 2, 2010, the Company entered into a lease agreement for approximately 28,633 square feet of office space in San Diego, CA (the "Premise"). The Company's current lease is scheduled to expire on December 31, 2010. Starting on January 1, 2011 the Premise will serve as the Company's new headquarters.

The New Lease has a term of sixty-five (65) months from the commencement date and provides for a one time termination option at the end of the fourth (4th) year. The New Lease provides for an initial monthly Base Rent payment through December 31, 2011 of one dollar and eighty-five cents (\$1.85) per rentable square foot per month (or approximately \$53,000), separately metered utilities, and an escalation clause under which annual rent is increased three percent (3.0%) per annum at each anniversary date. The New Lease provides that as long as the Company is not in economic or material non-economic default, for the month of January 2011, as well as for the period commencing April 1, 2011, and ending December 31, 2011, the Company will only be required to pay a monthly Base Rent in the amount of \$46,000 instead of \$53,000.

Pursuant to the terms of the Lease, the Company agreed to issue to the Lessor a Letter of Credit for the initial amount of \$250,000.

The Company currently leases approximately 56,000 square feet for its corporate office space. The lease expires on December 31, 2010 and calls for monthly rent of approximately \$142,000 per month.

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 on-demand, on-premises and hybrid SCM solutions to the mid enterprise and MSP markets. Our solutions help IT professionals effectively manage their enterprise's web and messaging security needs thru a differentiated, modular offering. Our Cloud Service Platform enables customers and MSP providers alike to easily provision the SCM solutions they need into an array of flexible deployment options. Our on-demand approach enables flexibility, scalability and reliability that optimizes TCO and TCA around our customers' budgetary needs. With an extensive ISP/MSP partner network, thousands of enterprises and millions of end users worldwide, St. Bernard is rapidly expanding its solution set into a larger, global footprint.

Customers can purchase our solutions directly from us, through a managed service provider, or via one of our Pro Partners around the world. On-premises purchases typically consist of an initial hardware purchase (appliance) and maintenance subscription, whereas our on-demand purchases contain only a subscription. Our primary customers are IT executives, managers and administrators as well as MSP's and ISP's.

Asset Purchase Agreement

On July 28, 2010, the Company entered into an Asset Purchase Agreement ("APA") with Red Condor and certain Noteholders of Red Condor, pursuant to which St. Bernard purchased substantially all of the assets and assumed certain liabilities of Red Condor in exchange for restricted shares of Common Stock of St. Bernard, subject to certain post-closing adjustments described in the Transaction. The assumed liabilities included approximately: (i) \$420,000 in accounts payable and (ii) \$42,000 of accrued vacation time. Included in the acquired assets was approximately \$638,000 in Red Condor accounts receivable.

The Transaction closed on August 2, 2010 (the "Closing Date"). On the Closing Date, and in consideration for the Transaction, St. Bernard issued to the Noteholders of Red Condor, 2,416,272 restricted shares of Common Stock (the "Purchase Shares"), of which 483,254 shares of Common Stock, are being held in Escrow for 18 months. In addition, in connection with the Transaction, the Company agreed to forgive the repayment of a previous advance to Red Condor in the aggregate amount of \$220,000.

Under the APA, St. Bernard agreed to offer employment to 34 employees of Red Condor, and agreed to continue relationships with certain independent contractors after the closing date.

Securities Purchase Agreement

On August 2, 2010, St. Bernard issued convertible notes (the "Notes") in the amount of \$3.2 million pursuant to a Securities Purchase Agreement ("SPA") with certain Noteholders (the "Investors"). Pursuant to the terms of the SPA, St. Bernard has issued to the Investors Notes and Warrants ("Warrants") to purchase up to 210,111 shares of Common

Stock in the aggregate. Under the terms of the Notes, the Notes mature on August 2, 2014. Interest on the outstanding principal balance accrues at a rate of three percent (3.0%) per annum and accrued interest is added to the balance of the Notes. All unpaid principal and interest on the Notes is due and payable at maturity. The Investors may convert the Notes at any time into shares of Common Stock of St. Bernard at a fixed conversion price of \$1.10. At any time after the issuance date of the Notes and prior to the Maturity Date, following the occurrence of any period of 60 consecutive trading days where the average closing price of the Common Stock of St. Bernard for such period is equal to or greater than \$1.25 per share, the entire unpaid principal amount of the Notes together with any unpaid interest shall be converted into Common Stock of St. Bernard at a conversion price of \$1.10. The Warrants have an exercise price equal to \$1.10 per share, are immediately exercisable and expire on August 2, 2014.

Our Financial Results

We reported revenues of \$4.6 million and \$4.5 million, respectively, for the three months ended September 30, 2010 and 2009; a net loss for the three months ended September 30, 2010 of \$1.3 million, compared to net income of \$117,000 for the same period in 2009; and net basic and diluted loss per share for the three months ended September 30, 2010 of \$0.09, compared to a net basic and diluted income per share of \$0.01 reported in the same period in 2009. The decrease in the basic and diluted loss per share was primarily attributable to a loss from operations of approximately \$1.2 million for the three months ended September 30, 2010 compared to income from operations of \$205,000 for the same period in 2009.

Cash used by operating activities increased \$862,000 to \$962,000 for the nine months ended September 30, 2010 compared to cash used by operating activities of \$100,000 for the same period in 2009. The net increase in the cash used by operating activities was due primarily to the increase in operating expenses as a result of the Red Condor transaction.

During the three months ended September 30, 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. We have also focused on transitioning all back-office operations of Red Condor to our San Diego location and expect to see operational savings in subsequent quarters.

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;
intangible assets;
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 September 30, 2010.

Results of Operations

Comparisons of the Three Months Ended September 30, 2010 and 2009 (in thousands, except percentages)

Revenues

| | For the Three Months Ended September 30, | | | |
|----------------|--|----------|--|----------|
| | 2010 | 2009 | | % Change |
| Total revenues | \$ 4,587 | \$ 4,493 | | 2.1% |

Revenues increased \$94,000 for the three months ended September 30, 2010, compared to the same period in 2009 primarily as a result of increases of \$8,000 in subscription revenues and \$86,000 in appliance revenues. Reported revenues for the three months ended September 30, 2010 exclude approximately \$178,000 of amounts that relate to services provided to former Red Condor, Inc. customers that were written down to fair value at the time of acquisition. See the discussion of changes in subscription and appliance revenues below.

Subscription Revenues

For the

| | Three Months Ended September 30, | | |
|-----------------------------------|-------------------------------------|----------|----------|
| | 2010 | 2009 | % Change |
| Subscription revenues | \$ 3,623 | \$ 3,615 | 0.2% |
| As a percentage of total revenues | 79.0% | 80.5% | |

For the three months ended September 30, 2010 our subscription revenues increased slightly compared to the same period in 2009 due to the addition of the Red Condor product line. Reported revenues for the three months ended September 30, 2010 exclude approximately \$178,000 of amounts that relate to services provided to former Red Condor, Inc. customers that were written down to fair value at the time of acquisition. The subscription renewal rates for our products range from 75% to 85%.

Appliance Revenues

| | For the Three Months Ended September 30, | | | |
|-----------------------------------|--|--------|--|----------|
| | 2010 | 2009 | | % Change |
| Appliance revenues | \$ 961 | \$ 875 | | 9.8% |
| As a percentage of total revenues | 21.0% | 19.5% | | |

For the three months ended September 30, 2010, appliance revenues increased approximately \$86,000 compared with the respective period in 2009. Total units shipped for the three months ended September 30, 2010 were 629 units compared with 595 units for the same period in 2009.

Cost of Revenues

| | For the Three Months Ended September 30, | | | |
|-------------------------|--|----------|--|----------|
| | 2010 | 2009 | | % Change |
| Total cost of revenues | \$ 1,330 | \$ 1,019 | | 30.5% |
| Gross margin percentage | 71.0% | 77.3% | | |

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 increased \$311,000 for the three months ended September 30, 2010 compared to the same period in 2009 primarily as a result of the acquisition of Red Condor on August 2, 2010. See the discussion of changes in the cost of subscription and appliance revenues below.

Cost of Subscription Revenues

| | For the Three Months Ended September 30, | | | |
|-------------------------------|--|--------|--|----------|
| | 2010 | 2009 | | % Change |
| Cost of subscription revenues | \$ 678 | \$ 416 | | 63.0% |
| Gross margin percentage | 81.3% | 88.5% | | |

The cost of subscription revenues includes the technical support group. The increase of \$262,000 for three months ended September 30, 2010 to the same period in 2009 is mainly due to increases to compensation expenses related to the acquired workforce of the Red Condor technical support group and the cost of sales for subscriptions for an additional product line.

Cost of Appliance Revenues

| | For the Three Months Ended September 30, | | | |
|----------------------------|--|--------|--|----------|
| | 2010 | 2009 | | % Change |
| Cost of appliance revenues | \$ 651 | \$ 594 | | 9.6% |

| | | |
|-------------------------|-------|-------|
| Gross margin percentage | 32.3% | 32.1% |
|-------------------------|-------|-------|

The cost of appliance revenues, which includes contract manufactured equipment, packaging and freight, increased \$57,000 for the three months ended September 30, 2010 compared to the same period in 2009 and gross margin remained relatively unchanged for the same period.

Sales and Marketing Expense

| | For the Three Months Ended September 30, | | | |
|-----------------------------------|--|----------|--|----------|
| | 2010 | 2009 | | % Change |
| Sales and marketing expense | \$ 1,868 | \$ 1,474 | | 26.7% |
| As a percentage of total revenues | 40.7% | 32.8% | | |

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 September 30, 2010, sales and marketing expense increased 26.7%, or approximately \$394,000, over the same period in 2009 primarily due to increases to compensation expenses including commissions and additional advertising expenses.

Research and Development Expense

| | For the Three Months Ended September 30, | | |
|-----------------------------------|--|--------|----------|
| | 2010 | 2009 | % Change |
| Research and development expense | \$ 1,249 | \$ 860 | 45.2% |
| As a percentage of total revenues | 27.2% | 19.1% | |

Research and development expense consists primarily of salaries, related benefits, third-party consultant fees and other engineering related costs. The net increase of \$389,000 for the three months ended September 30, 2010 compared to the same period in 2009 was primarily the result of a net increase in compensation costs due to the acquired workforce from Red Condor, offset by a net decrease to consulting expenses. This additional workforce will continue to maintain the Red Condor Technology while integrating with our other products.

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 September 30, | | |
|------------------------------------|--|--------|----------|
| | 2010 | 2009 | % Change |
| General and administrative expense | \$ 1,330 | \$ 462 | 187.9% |
| As a percentage of total revenues | 29.0% | 10.3% | |

General and administrative expenses, which consist primarily of salaries and related benefits, and fees for professional services, such as legal and accounting services, increased approximately \$868,000 for the three months ended September 30, 2010, compared to the same period in 2009. The most significant increases during the three months ended September 30, 2010 included increases in legal and accounting expenses of approximately \$256,000 related to the acquisition of Red Condor, stock-based compensation expenses of \$235,000, compensation expenses of \$221,000 related to the acquisition of the Red Condor workforce and the addition of an executive position, and an increase in lease and rents expense of \$105,000. The increase in stock-based compensation expenses was mainly attributable to lower expenses during 2009 relating to the vesting of stock options to the Company's former CEO. During 2009, we subleased approximately 30,000 square feet of our unused office space to a company. The proceeds from the sublease were used to offset our monthly facilities rent expense.

Write-off of Capitalized Software

| | For the Three Months Ended September 30, | | |
|-----------------------------------|--|--------|----------|
| | 2010 | 2009 | % Change |
| Write-off of capitalized software | \$ 0 | \$ 473 | (100.0)% |

| | | |
|-----------------------------------|------|-------|
| As a percentage of total revenues | 0.0% | 10.5% |
|-----------------------------------|------|-------|

In accordance with ASC 350-40-25-2, “Intangibles-Goodwill and Other – Internal Use Software”(formerly Statement of Position 98-1, “Accounting for the Costs of Computer Software Developed or Obtained for Internal Use”), the Company capitalized internal software development costs, which included certain payroll and payroll related costs for employees and contracting costs for software contractors who were directly associated with the development phase of the internal-use software from September 2008 through June 2009. In June 2009, a decision to suspend further development of this software was made by management. On October 5, 2009, management determined that given certain personnel changes, the estimated costs to complete development and maintain this new software far outweighed the potential benefit that would be received, and the project was scrapped. As such, the Company has written off previously capitalized software costs related to the development of this software of approximately \$473,000 during the quarter ended September 30, 2009.

Interest and Other Income, Net

| | For the Three Months Ended September 30, | | | |
|-----------------------------------|--|-------|--|----------|
| | 2010 | 2009 | | % Change |
| Interest and other income, net | \$ 116 | \$ 88 | | 31.8% |
| As a percentage of total revenues | 2.5% | 2.0% | | |

Interest and other income, net, includes interest expense, interest income, and other income. The increase for the three months ended September 30, 2010 over the same period in 2009 was the result of an increase to other income related to the warrant derivative, offset by a decrease in interest expense related to short-term borrowings.

Comparisons of the Nine months Ended September 30, 2010 and 2009 (in thousands, except percentages)

Revenues

| | For the Nine months Ended September 30, | | | |
|----------------|---|-----------|--|----------|
| | 2010 | 2009 | | % Change |
| Total revenues | \$ 13,317 | \$ 13,696 | | (2.8)% |

Revenues decreased \$379,000 for the nine months ended September 30, 2010, compared to the same period in 2009 primarily as a result of decreases of \$462,000 in subscription revenues, offset by increases in appliance revenues of \$36,000 and \$47,000 in license revenues. Reported revenues for the nine months ended September 30, 2010 exclude approximately \$178,000 of amounts that relate to services provided to former Red Condor, Inc. customers that were written down to fair value at the time of acquisition. See the discussion of changes in subscription and appliance revenues below.

Subscription Revenues

| | For the Nine months Ended September 30, | | | |
|-----------------------------------|---|-----------|--|----------|
| | 2010 | 2009 | | % Change |
| Subscription revenues | \$ 10,534 | \$ 10,996 | | (4.2)% |
| As a percentage of total revenues | 79.1% | 80.3% | | |

For the nine months ended September 30, 2010 our subscription revenues decreased approximately \$462,000 compared to the same period in 2009 primarily due to pricing pressures to discount our subscription products to stay competitive in the current economy. Reported revenues for the nine months ended September 30, 2010 exclude approximately \$178,000 of amounts that relate to services provided to former Red Condor, Inc. customers that were written down to fair value at the time of acquisition. The subscription renewal rates for our products range from 75% to 85%.

Appliance Revenues

For the
Nine months Ended
September 30,

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| | 2010 | 2009 | % Change |
|-----------------------------------|----------|----------|----------|
| Appliance revenues | \$ 2,727 | \$ 2,691 | 1.3% |
| As a percentage of total revenues | 20.5% | 19.6% | |

For the nine months ended September 30, 2010, appliance revenues increased approximately \$36,000 compared with the respective period in 2009. Total units shipped for the nine months ended September 30, 2010 were 1,816 units compared with 1,837 units for the same period in 2009. Though we shipped out fewer appliance units, the increase in revenue can be attributed to a noticeable shift in customer demand toward the higher-end models.

Cost of Revenues

| | For the Nine months Ended September 30, | | | % Change |
|-------------------------|---|----------|--|----------|
| | 2010 | 2009 | | |
| Total cost of revenues | \$ 3,385 | \$ 3,153 | | 7.4% |
| Gross margin percentage | 74.6% | 77.0% | | |

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 increased \$232,000 for the nine months ended September 30, 2010 compared to the same period in 2009 primarily as a result of increases of \$172,000 in cost of subscription revenues, \$58,000 in cost of appliances, and \$2,000 in cost of licenses. See the discussion of changes in the cost of subscription and appliance revenues below.

Cost of Subscription Revenues

| | For the Nine months Ended September 30, | | |
|-------------------------------|---|----------|----------|
| | 2010 | 2009 | % Change |
| Cost of subscription revenues | \$ 1,488 | \$ 1,316 | 13.1% |
| Gross margin percentage | 85.9% | 88.0% | |

The cost of subscription revenues includes the technical support group. The increase of \$172,000 for nine months ended September 30, 2010 to the same period in 2009 is mainly due to increases to compensation expenses related to the acquired workforce of the Red Condor technical support group and the cost of sales for subscriptions for an additional product line.

Cost of Appliance Revenues

| | For the Nine months Ended September 30, | | |
|----------------------------|---|----------|----------|
| | 2010 | 2009 | % Change |
| Cost of appliance revenues | \$ 1,884 | \$ 1,826 | 3.2% |
| Gross margin percentage | 30.9% | 32.1% | |

The cost of appliance revenues, which includes contract manufactured equipment, packaging and freight increased \$58,000 for the nine months ended September 30, 2010 compared to the same period in 2009. Gross margin decreased slightly for the period mentioned above.

Sales and Marketing Expense

| | For the Nine months Ended September 30, | | |
|-----------------------------------|---|----------|----------|
| | 2010 | 2009 | % Change |
| Sales and marketing expense | \$ 5,288 | \$ 4,715 | 12.2% |
| As a percentage of total revenues | 39.7% | 34.4% | |

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 nine months ended September 30, 2010 sales and marketing expense increased 12.2%, or approximately \$573,000, over the same period in 2009 primarily due to increases to compensation expenses related to the acquired workforce from Red Condor and additional advertising expenses.

Research and Development Expense

| | For the Nine months Ended September 30, | | |
|-----------------------------------|---|----------|----------|
| | 2010 | 2009 | % Change |
| Research and development expense | \$ 2,964 | \$ 2,988 | (0.8)% |
| As a percentage of total revenues | 22.3% | 21.8% | |

Research and development expense consists primarily of salaries, related benefits, third-party consultant fees and other engineering related costs. The net decrease of \$24,000 for the nine months ended September 30, 2010 compared to the same period in 2009 was primarily the result of an increase in compensation costs related to the acquired workforce of Red Condor research and development engineers, offset by the transitioning of research and development expenses in-house. During 2009, the Company modified its consulting agreement with Softworks Group Pty Ltd. As a result, the majority of research and development was moved in-house to Company headquarters during the latter half of 2009, eventually leading to the transitioning of 100% of the research and development expenses in-house during 2010, resulting in a significant decrease in research and development related 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 Nine months Ended September 30, | | |
|------------------------------------|---|----------|----------|
| | 2010 | 2009 | % Change |
| General and administrative expense | \$ 3,335 | \$ 2,709 | 23.1% |
| As a percentage of total revenues | 25.0% | 19.8% | |

General and administrative expenses, which consist primarily of salaries and related benefits, and fees for professional services, such as legal and accounting services, increased approximately \$626,000 for the nine months ended September 30, 2010, compared to the same period in 2009. The most significant increases during the three months ended September 30, 2010 included increases in lease and rents expense of \$427,000, compensation expenses of \$397,000 related to the acquisition of the Red Condor workforce and the addition of an executive position, legal and accounting expenses of approximately \$229,000 related to the acquisition of Red Condor, offset by stock-based compensation expenses of \$350,000. The decrease in stock-based compensation expenses was mainly attributable to expenses in the 2009 period relating to the vesting of stock options to the Company's former CEO. During 2009, we subleased approximately 30,000 square feet of our unused office space to a company. The proceeds from the sublease were used to offset our monthly facilities rent expense.

Write-off of Capitalized Software

| | For the Nine Months Ended September 30, | | |
|-----------------------------------|---|--------|----------|
| | 2010 | 2009 | % Change |
| Write-off of capitalized software | \$ 0 | \$ 473 | (100.0)% |
| As a percentage of total revenues | 0.0% | 3.5% | |

In accordance with ASC 350-40-25-2, "Intangibles-Goodwill and Other – Internal Use Software" (formerly Statement of Position 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use"), the Company capitalized internal software development costs, which included certain payroll and payroll related costs for employees and contracting costs for software contractors who were directly associated with the development phase of the internal-use software from September 2008 through June 2009. In June 2009, a decision to suspend further development of this software was made by management. On October 5, 2009, management determined that given certain personnel changes, the estimated costs to complete development and maintain this new software far outweighed the potential benefit that would be received, and the project was scrapped. As such, the Company has written off previously capitalized software costs related to the development of this software of approximately \$473,000 during the quarter ended September 30, 2009.

Interest and Other Income, Net

| | For the Nine months Ended September 30, | | |
|--------------------------------|---|--------|----------|
| | 2010 | 2009 | % Change |
| Interest and other income, net | \$ 232 | \$ 221 | 5.0% |

| | | |
|-----------------------------------|------|------|
| As a percentage of total revenues | 1.7% | 1.6% |
|-----------------------------------|------|------|

Interest and other income, net, includes interest expense, interest income, and other income. The increase for the nine months ended September 30, 2010 over the same period in 2009 was the result of an increase to other income related to the warrant derivative, offset by a decrease to other income related to interest expense due to short-term borrowings.

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 used by operating activities was \$1.0 million and \$100,000 for the nine months ended September 30, 2010 and 2009, respectively. The net increase in use of cash by operating activities was primarily due to the increase in general operating expenses and operating expenses associated with Red Condor.

For the nine months ended September 30, 2010 and 2009, cash used by investing activities was \$125,000 and \$75,000, respectively.

Cash flows provided by financing activities for the nine months ended September 30, 2010 was \$1.4 million and cash used by financing activities for the same period in 2009 was \$455,000. The increase in cash provided by financing was primarily due to the proceeds from a convertible note as part of a Securities Purchase Agreement dated August 2, 2010, offset by a decrease in short-term borrowings.

As a result of the foregoing, the net increase in cash and cash equivalents was \$335,000 for the nine months ended September 30, 2010 as compared to a net decrease in cash of approximately \$630,000 for the comparable period in 2009.

Credit Facilities

On May 15, 2007, the Company entered into a Loan and Security Agreement with SVB (the "SVB Loan Agreement"). The SVB Loan Agreement was amended on February 27, 2009, March 23, 2010, and on September 29, 2010. 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) increased the Cash Sublimit, FX (foreign exchange) Sublimit and the Letter of Credit Sublimit from \$250,000 to \$650,000, (iii) 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%), (iv) 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 September 30, 2010 and the principal amount of subordinated debt received after September 30, 2010, (v) modified the borrowing base to eighty percent (80%) of eligible accounts, and (vi) extended the revolving line maturity date to May 15, 2011. At September 30, 2010, total availability under the SVB Loan Agreement was \$1.9 million, of which \$0 was outstanding with an applicable interest rate of 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 was used to repay indebtedness owing from PFG during July 2010. Term Loan A, which has a maturity date of May 15, 2011, 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, which has a maturity date of July 20, 2012,

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%). At September 30, 2010, the total amount outstanding under Term Loan A and Term Loan B were \$300,000 and \$183,000, respectively. The interest expense for Term Loans A and B for the three months and nine months ended September 30, 2010 was approximately \$6,000.

Convertible Notes

On August 2, 2010, St. Bernard issued convertible notes (the "Notes") in the amount of \$3.2 million pursuant to a Securities Purchase Agreement ("SPA") with certain Noteholders (the "Investors"). Pursuant to the terms of the SPA, St. Bernard has issued to the Investors Notes and Warrants ("Warrants") to purchase up to 210,111 shares of Common Stock in the aggregate. Under the terms of the Notes, the Notes mature on August 2, 2014. Interest on the outstanding principal balance accrues at a rate of three percent (3.0%) per annum and accrued interest is added to the balance of the Notes. All unpaid principal and interest on the Notes is due and payable at maturity. The Investors may convert the Notes at any time into shares of Common Stock of St. Bernard at a fixed conversion price of \$1.10. At any time after the issuance date of the Notes and prior to the Maturity Date, following the occurrence of any period of 60 consecutive trading days where the average closing price of the Common Stock of St. Bernard for such period is equal to or greater than \$1.25 per share, the entire unpaid principal amount of the Notes together with any unpaid interest shall be converted into Common Stock of St. Bernard at a conversion price of \$1.10. The Warrants have an exercise price equal to \$1.10 per share, are immediately exercisable and expire on August 2, 2014.

Liquidity

As of September 30, 2010, the Company had approximately \$2.8 million in cash and cash equivalents and a working capital deficit of \$6.7 million. Approximately \$10.9 million of the Company's current liability balance at September 30, 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 nine months ended September 30, 2010, the Company incurred a net loss of \$1.9 million, and through September 30, 2010 has recorded a cumulative net loss of \$51.6 million. For the nine months ended September 30, 2010 net cash used by operating activities was \$962,000.

As described at Note 4 to the accompanying financial statements, the Company has existing credit facilities with Silicon Valley Bank ("SVB"), under which there is borrowing availability of \$1.9 million as of September 30, 2010. On July 20, 2010, a note \$750,000 from Partner for Growth ("PFG") note was paid off and during the three months ended September 30, 2010, the Company received proceeds of \$3.2 million in connection with the issuance of subordinated convertible notes.

The Company believes that its existing cash resources as of September 30, 2010, combined with proceeds from the issuance of convertible notes in July 2010, projected collections on billings, and borrowing availability under existing SVB 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.

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.

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 September 7, 2010, an action was filed in the United States District Court Eastern District of Texas by Wordcheck Tech, LLC (the "Plaintiff") against the Company as well as ALT-N TECHNOLOGIES, LTD.; APPRIVER LLC; ATHENA ARCHIVER, INC.; AWARENESS TECHNOLOGIES, INC.; AXS- ONE, INC.; BITDEFENDER LLC; BLUE COAT SYSTEMS, INC.; CA, INC. D/B/A CA TECHNOLOGIES; CHECK POINT SOFTWARE TECHNOLOGIES, INC.; CHECK POINT SOFTWARE, LLC; CODE GREEN NETWORKS INTERNATIONAL, INC. ; CODE GREEN NETWORKS, INC.; COMPUTER ASSOCIATES INTERNATIONAL, INC.; COMPUTER MAIL SERVICES, INC.; ELECTRIC MAIL (INTERNATIONAL) L.P.; EMC CORPORATION; ENTRUST, INC. D/B/A ENTRUST TECHNOLOGIES, INC.; ESOFT, INC.; FACETIME COMMUNICATIONS, INC.; FIDELIS SECURITY SYSTEMS, INC.; FORTINET, INC.; GFI SOFTWARE DEVELOPMENT, LTD.; GFI USA, INC.; GLOBAL RELAY COMMUNICATIONS, INC.; GLOBAL RELAY USA, INC.; GTB TECHNOLOGIES, INC.; INTEGO, INC.; IRON MOUNTAIN INC. D/B/A IRON MOUNTAIN COMPANY; ITECH, INC.; J2 GLOBAL COMMUNICATIONS, INC.; LIVEOFFICE HOLDINGS, LLC; LIVEOFFICE, LLC; MICROWORLD TECHNOLOGIES, INC.; MIMICAST NORTH AMERICA, INC.; MIMICAST SERVICES LTD.; MIMICAST, LTD.; MIMOSA SYSTEMS, INC.; PALISADE SYSTEMS, INC.; PERMESSA CORPORATION; QUEST SOFTWARE, INC.; RED EARTH SOFTWARE (UK) LTD.; RED EARTH SOFTWARE, INC.; ROCKLIFFE SYSTEMS D/B/A ROCKLIFFE SYSTEMS, INC. D/B/A ROCKLIFFE, INC. D/B/A MAILSITE, INC.; RSA SECURITY, INC.; RSA SECURITY, LLC; SAFENET, INC.; SHERPA SOFTWARE GROUP, INC. D/B/A SHERPA SOFTWARE; SHERPA SOFTWARE GROUP, L.P. A/K/A SHERPA SOFTWARE PARTNERS, L.P.

D/B/A SHERPA SOFTWARE; SMARSH, INC.; SOLINUS, INC., D/B/A MAILFOUNDRY; THE ELECTRIC MAIL COMPANY; TRUSTWAVE CORPORATION; TRUSTWAVE HOLDINGS, INC.; UNIFY CORPORATION; VERDASYS INC.; VERICEPT CORPORATION; VIRTUALCONNECT TECHNOLOGIES, INC.; WATCHGUARD TECHNOLOGIES, INC.; WATERFORD TECHNOLOGIES GROUP, LTD. D/B/A WATERFORD TECHNOLOGIES GROUP; WATERFORD TECHNOLOGIES, INC. D/B/A SEATTLELAB, INC. D/B/A SEATTLELAB; WORKSHARE TECHNOLOGY, INC. D/B/A WORKSHARE, INC.; ZL TECHNOLOGIES, INC.; and ZSCALER, 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. 6,782,510 entitled “Word Checking Tool For Controlling The Language Content In Documents Using Dictionaries With Modifyable Status Fields” which was issued on August 24, 2004. The Plaintiff is seeking a judgment in favor of Plaintiff, including a permanent injunction, and is seeking an award of unspecified damages. The Company intends to vigorously defend 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

On August 2, 2010, St. Bernard issued convertible notes (the "Notes") in the amount of \$3.2 million pursuant to a Securities Purchase Agreement ("SPA") with certain Noteholders (the "Investors"). Pursuant to the terms of the SPA, St. Bernard has agreed to issued to the Investors Notes and Warrants ("Warrants") to purchase up to 210,111 shares of Common Stock in the aggregate. Under the terms of the Notes, the Notes mature on August 2, 2014. Interest on the outstanding principal balance accrues at a rate of three percent (3.0%) per annum and accrued interest is added to the balance of the Notes. All unpaid principal and interest on the Notes is due and payable at maturity. The Investors may convert the Notes at any time into shares of Common Stock of St. Bernard at a fixed conversion price of \$1.10. At any time after the issuance date of the Notes and prior to the Maturity Date, following the occurrence of any period of 60 consecutive trading days where the average closing price of the Common Stock of St. Bernard for such period is equal to or greater than \$1.25 per share, the entire unpaid principal amount of the Notes together with any unpaid interest shall be converted into Common Stock of St. Bernard at a conversion price of \$1.10. The Warrants have an exercise price equal to \$1.10 per share, are immediately exercisable and expire on August 2, 2014.

Item 3. Defaults Upon Senior Securities

None.

Item 4. [Removed and Reserved]

Item 5. Other Information

None.

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 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).
- 4.5 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).
- 4.6 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).
- 4.7 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).
- 4.8 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).
- 4.9 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).

- 4.10 Warrant Purchase Agreement between St. Bernard Software, Inc. and RWI Ventures II, L.P. dated July 28, 2010 (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 August 3, 2010).
- 4.11 Convertible Note Agreement between St. Bernard Software, Inc. and certain Noteholders dated July 28, 2010 (incorporated herein by reference to Exhibit 10.3 to the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on August 3, 2010).

- 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).

10.14* Employment agreement between St. Bernard Software, Inc. and Brian Nugent executed April 28, 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 May 4, 2010).

10.15 Lease Agreement between St. Bernard Software, Inc. and Kilroy Realty, L.P., dated August 2, 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 August 6, 2010).

10.16 Seventh Amendment to Loan and Security Agreement between St. Bernard Software, Inc. and Silicon Valley Bank dated September 29, 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 October 5, 2010).

10.17 Asset Purchase Agreement between St. Bernard Software, Inc. and Red Condor, Inc. dated July 28, 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 August 3, 2010.)

10.18 Amendment No. 1 to the Asset Purchase Agreement between St. Bernard Software, Inc. and Red Condor, Inc. dated July 28, 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 October 13, 2010.)

31.1 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.

* 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: November 15, 2010

By:

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