

L-1 IDENTITY SOLUTIONS, INC.

Form 10-Q

November 03, 2010

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q**

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES  
EXCHANGE ACT OF 1934**  
**For the Quarterly Period Ended 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 001-33002**  
**L-1 IDENTITY SOLUTIONS, INC.**  
(Exact name of registrant as specified in its charter)

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

**02-0807887**  
(I.R.S. Employer  
Identification No.)

**177 Broad Street, 12th Floor, Stamford, CT**  
(Address of principal executive offices)

**06901**  
(Zip Code)

**(203) 504-1100**

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 website, 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 ☐

(Do not check if a smaller reporting company)

Indicate by a check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act) ☐ Yes ☒ No

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

| Class                          | Outstanding at<br>November 1, 2010 |
|--------------------------------|------------------------------------|
| Common stock, \$.001 par value | 93,534,981                         |



**L-1 IDENTITY SOLUTIONS, INC.**  
**FORM 10-Q FOR THE QUARTER ENDED SEPTEMBER 30, 2010**  
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**PART 1 FINANCIAL INFORMATION**  
**ITEM 1 UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**L-1 IDENTITY SOLUTIONS, INC.**  
**Condensed Consolidated Balance Sheets**  
**(in thousands)**  
**(Unaudited)**

|   | <b>September<br/>30,<br/>2010</b> | <b>December<br/>31,<br/>2009</b> |
|---|-----------------------------------|----------------------------------|
| <b>Assets</b>   |                                   |                                  |
| Current assets:   |                                   |                                  |
| Cash and cash equivalents   | \$ 9,026                          | \$ 6,624                         |
| Accounts receivable, net  | 89,596                            | 116,353                          |
| Inventory, net  | 34,978                            | 29,384                           |
| Deferred tax asset, net   | 9,788                             | 11,514                           |
| Other current assets  | 7,651                             | 9,249                            |
| Assets held for sale  | 262,640                           |                                  |
| <br>Total current assets  | <br>413,679                       | <br>173,124                      |
| Property and equipment, net   | 122,098                           | 115,500                          |
| Goodwill  | 700,768                           | 889,814                          |
| Intangible assets, net  | 61,773                            | 102,375                          |
| Deferred tax assets, net  | 47,864                            | 26,733                           |
| Other assets, net   | 15,385                            | 16,279                           |
| <br>Total assets  | <br>\$ 1,361,567                  | <br>\$ 1,323,825                 |
| <br><b>Liabilities and Equity</b>   |                                   |                                  |
| Current liabilities:  |                                   |                                  |
| Accounts payable and accrued expenses   | \$ 88,033                         | \$ 110,089                       |
| Current portion of deferred revenue   | 19,129                            | 19,890                           |
| Current maturities of long-term debt  | 268,262                           | 27,062                           |
| Other current liabilities   | 7,275                             | 6,680                            |
| Liabilities related to assets held for sale   | 37,001                            |                                  |
| <br>Total current liabilities   | <br>419,700                       | <br>163,721                      |
| Deferred revenue, net of current portion  | 4,927                             | 6,676                            |
| Long-term debt, net of current maturities   | 199,804                           | 419,304                          |
| Other long-term liabilities   | 4,643                             | 3,663                            |
| <br>Total liabilities   | <br>629,074                       | <br>593,364                      |
| <br>Equity:   |                                   |                                  |
| Common stock, \$0.001 par value; 125,000,000 shares authorized;<br>93,682,240 and 91,745,135 shares issued at September 30, 2010 and<br>December 31, 2009, respectively | <br><br>94                        | <br><br>92                       |
| Additional paid-in capital  | 1,454,535                         | 1,432,898                        |

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|  |              |              |
|--|--------------|--------------|
| Accumulated deficit  | (646,881)    | (627,449)    |
| Pre-paid forward contract  | (69,808)     | (69,808)     |
| Treasury stock, 384,690 and 368,843 shares of common stock, at cost at<br>September 30, 2010 and December 31, 2009, respectively | (6,316)      | (6,173)      |
| Accumulated other comprehensive income   | 570          | 622          |
| Noncontrolling interest  | 299          | 279          |
| Total equity   | 732,493      | 730,461      |
| Total liabilities and equity   | \$ 1,361,567 | \$ 1,323,825 |

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

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**L-1 IDENTITY SOLUTIONS, INC.**  
**Condensed Consolidated Statements of Operations**  
(in thousands, except per share data)  
(Unaudited)

|  | <b>Three Months Ended</b> |                  | <b>Nine Months Ended</b> |                  |
|--|---------------------------|------------------|--------------------------|------------------|
|  | <b>September</b>          | <b>September</b> | <b>September</b>         | <b>September</b> |
|  | <b>30,</b>                | <b>30,</b>       | <b>30,</b>               | <b>30,</b>       |
|  | <b>2010</b>               | <b>2009</b>      | <b>2010</b>              | <b>2009</b>      |
| <b>Revenues</b>  | \$ 121,012                | \$ 119,233       | \$ 323,609               | \$ 330,136       |
| <b>Cost of revenues:</b>   |                           |                  |                          |                  |
| Cost of revenues   | 82,299                    | 78,480           | 227,743                  | 225,526          |
| Amortization of acquired intangible assets                               | 1,334                     | 1,260            | 3,894                    | 4,094            |
| Total cost of revenues   | 83,633                    | 79,740           | 231,637                  | 229,620          |
| <b>Gross profit</b>  | 37,379                    | 39,493           | 91,972                   | 100,516          |
| <b>Operating expenses:</b>   |                           |                  |                          |                  |
| Sales and marketing  | 9,344                     | 10,476           | 27,698                   | 29,839           |
| Research and development   | 6,262                     | 6,114            | 16,787                   | 17,679           |
| General and administrative   | 16,658                    | 14,571           | 42,650                   | 42,363           |
| Asset impairment charge  | 2,915                     |                  | 2,915                    |                  |
| Strategic alternative transactions and acquisition related costs         | 6,063                     | 27               | 7,971                    | 506              |
| Total operating expenses   | 41,242                    | 31,188           | 98,021                   | 90,387           |
| <b>Operating income (loss)</b>   | (3,863)                   | 8,305            | (6,049)                  | 10,129           |
| Financing costs:   |                           |                  |                          |                  |
| Contractual interest   | (2,515)                   | (1,797)          | (7,108)                  | (5,674)          |
| Other financing costs  | (1,865)                   | (1,871)          | (5,475)                  | (5,191)          |
| Other expense, net   | (226)                     | (92)             | (404)                    | (47)             |
| <b>(Loss) income before income taxes and discontinued operations</b>     | (8,469)                   | 4,545            | (19,036)                 | (783)            |
| (Provision) benefit for income taxes                                     | 1,899                     | (1,506)          | 4,078                    | (168)            |
| <b>Net (loss) income from continuing operations, net of income taxes</b> | (6,570)                   | 3,039            | (14,958)                 | (951)            |
| <b>Net loss from discontinued operations, net of income taxes</b>        | (2,605)                   | (1,667)          | (4,454)                  | (2,707)          |
| <b>Net (loss) income</b>   | (9,175)                   | 1,372            | (19,412)                 | (3,658)          |
| Net loss (income) attributable to noncontrolling interest                | 9                         |                  | (20)                     |                  |
|  | \$ (9,166)                | \$ 1,372         | \$ (19,432)              | \$ (3,658)       |

**Net income (loss) attributable to L-1 s shareholders**

**Basic net (loss) income per share:**

|                                    |           |           |           |           |
|------------------------------------|-----------|-----------|-----------|-----------|
| Continued operations               | \$ (0.07) | \$ 0.04   | \$ (0.17) | \$ (0.01) |
| Discontinued operations            | \$ (0.03) | \$ (0.02) | \$ (0.05) | \$ (0.03) |
| Attributable to L-1 s shareholders | \$ (0.10) | \$ 0.02   | \$ (0.22) | \$ (0.04) |

**Diluted net (loss) income per share:**

|                                    |           |           |           |           |
|------------------------------------|-----------|-----------|-----------|-----------|
| Continued operations               | \$ (0.07) | \$ 0.04   | \$ (0.17) | \$ (0.01) |
| Discontinued operations            | \$ (0.03) | \$ (0.02) | \$ (0.05) | \$ (0.03) |
| Attributable to L-1 s shareholders | \$ (0.10) | \$ 0.02   | \$ (0.22) | \$ (0.04) |

**Weighted average common shares outstanding:**

|         |        |        |        |        |
|---------|--------|--------|--------|--------|
| Basic   | 87,971 | 85,901 | 87,491 | 85,301 |
| Diluted | 87,971 | 86,007 | 87,491 | 85,301 |

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



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**L-1 IDENTITY SOLUTIONS, INC.**  
**Condensed Consolidated Statements of Changes in Equity**  
(In thousands)  
(Unaudited)

|  | Series A        |                                   | Additional         |                        | Pre-paid<br>Forward<br>Contract<br>To<br>Purchase | Accumulated<br>Other<br>Comprehensive<br>Income | Non-<br>Controlling<br>Interest |            |
|--|-----------------|-----------------------------------|--------------------|------------------------|---|---|---------------------------------|------------|
|  | Common<br>Stock | Convertible<br>Preferred<br>Stock | Paid-in<br>Capital | Accumulated<br>Deficit | Common<br>Stock                                   | Treasury<br>Stock                               |                                 | Total      |
| Balance, January 1, 2009                                     | \$ 87           | \$ 15,107                         | \$ 1,393,763       | \$ (623,251)           | \$ (69,808)                                       | \$ (6,161)                                      | \$ (1,257)                      | \$ 708,480 |
| Reclassification of<br>noncontrolling interest               |                 |                                   |                    |                        |   |   | 84                              | 84         |
| Exercise of employee stock<br>options                        |                 |                                   | 87                 |                        |   |   |                                 | 87         |
| Common stock issued for<br>directors' fees                   |                 |                                   | 208                |                        |   |   |                                 | 208        |
| Common stock issued under<br>employee stock purchase<br>plan | 1               |                                   | 3,351              |                        |   |   |                                 | 3,352      |
| Deferred tax charge of stock<br>options exercised            |                 |                                   | (845)              |                        |   |   |                                 | (845)      |
| Retirement plan contribution<br>settled in common stock      | 2               |                                   | 8,468              |                        |   |   |                                 | 8,470      |
| Stock-based compensation<br>expense                          | 1               |                                   | 12,941             |                        |   |   |                                 | 12,942     |
| Conversion of Series A<br>convertible preferred stock        | 1               | (15,107)                          | 15,106             |                        |   |   |                                 |            |
| Foreign currency translation<br>gain                         |                 |                                   |                    |                        |   |   | 1,391                           | 1,391      |
| Unrealized gain of financial<br>instruments, net of tax      |                 |                                   |                    |                        |   |   | 488                             | 488        |
| Net income (loss)  |                 |                                   |                    | (4,198)                |   |   | 195                             | (4,003)    |
| Other  |                 |                                   | (181)              |                        |   | (12)  |                                 | (193)      |
| Balance, December 31, 2009                                   | \$ 92           | \$                                | \$ 1,432,898       | \$ (627,449)           | \$ (69,808)                                       | \$ (6,173)                                      | \$ 622                          | \$ 730,461 |
| Exercise of employee stock<br>options                        |                 |                                   | 766                |                        |   |   |                                 | 766        |
| Common stock issued for<br>directors' fees                   |                 |                                   | 900                |                        |   |   |                                 | 900        |
| Common stock issued under<br>employee stock purchase<br>plan |                 |                                   | 2,542              |                        |   |   |                                 | 2,542      |
| Retirement plan contributions<br>settled in common stock     | 2               |                                   | 9,026              |                        |   |   |                                 | 9,028      |

|  |       |          |  |  |       |    |  |          |
|--|-------|----------|--|--|-------|----|--|----------|
| Stock-based compensation expense                     | 8,403 |          |  |  |       |    |  | 8,403    |
| Foreign currency translation loss                    |       |          |  |  | (295) |    |  | (295)    |
| Unrealized gain of financial instruments, net of tax |       |          |  |  | 243   |    |  | 243      |
| Net income (loss)                                    |       | (19,432) |  |  |       | 20 |  | (19,412) |
| Other  |       |          |  |  | (143) |    |  | (143)    |

Balance, September 30, 2010 \$ 94 \$ \$ 1,454,535 \$ (646,881) \$ (69,808) \$ (6,316) \$ 570 \$ 299 \$ 732,493

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

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**L-1 IDENTITY SOLUTIONS, INC.**  
**Condensed Consolidated Statements of Cash Flows**  
(in thousands)  
(Unaudited)

|  | Nine Months Ended<br>September<br>30,<br>2010 | September<br>30,<br>2009 |
|--|---|--------------------------|
| <b>Cash Flow from Operating Activities:</b>                                      |   |                          |
| Net loss   | \$ (19,412)                                   | \$ (3,658)               |
| Adjustments to reconcile net loss to net cash provided by operating activities:  |   |                          |
| Depreciation and amortization  | 31,350  | 27,411                   |
| Stock-based compensation costs   | 18,008  | 16,225                   |
| Benefit for non-cash income taxes  | (6,318)                                       | (1,428)                  |
| Amortization of deferred financing costs and debt discount                       | 9,049   | 10,354                   |
| Asset impairments charge   | 2,915   |                          |
| Other non-cash items   | (69)  |                          |
| Change in operating assets and liabilities, net of effects of acquisitions:      |   |                          |
| Accounts receivable  | (7,377)                                       | (21,571)                 |
| Inventory  | (4,911)                                       | 4,137                    |
| Other assets   | 323   | 6,435                    |
| Accounts payable, accrued expenses and other liabilities                         | 6,625   | 17,614                   |
| Deferred revenue   | (2,532)                                       | (7,773)                  |
| Net cash provided by operating activities  | 27,651  | 47,746                   |
| <b>Cash Flow from Investing Activities:</b>                                      |   |                          |
| Acquisitions   | (3,771)                                       | (3,228)                  |
| Capital expenditures   | (32,558)                                      | (38,423)                 |
| Additions to intangible assets   | (4,822)                                       | (6,151)                  |
| Increase in restricted cash  | (1,043)                                       | (67)                     |
| Net cash used in investing activities  | (42,194)                                      | (47,869)                 |
| <b>Cash Flow from Financing Activities:</b>                                      |   |                          |
| Borrowings under revolving credit agreement                                      | 61,158  |                          |
| Principal payments on borrowings under revolving credit agreement and other debt | (31,691)                                      | (631)                    |
| Principal payments on term loan  | (13,052)                                      | (9,843)                  |
| Debt and equity issuance costs   | (2,410)                                       | (822)                    |
| Proceeds from issuance of common stock to employees                              | 1,999   | 1,770                    |
| Proceeds from exercise of stock options by employees                             | 766   | 51                       |
| Net cash provided by (used in) financing activities                              | 16,770  | (9,475)                  |
| Effect of exchange rate changes on cash and cash equivalents                     | 175   | 200                      |
| Net increase (decrease) in cash and cash equivalents                             | 2,402   | (9,398)                  |

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|  |          |           |
|--|----------|-----------|
| Cash and cash equivalents, beginning of year | 6,624    | 20,449    |
| Cash and cash equivalents, end of period     | \$ 9,026 | \$ 11,051 |

**Supplemental Cash Flow Information:**

|                            |           |           |
|----------------------------|-----------|-----------|
| Cash paid for interest     | \$ 21,231 | \$ 19,657 |
| Cash paid for income taxes | \$ 283    | \$ 1,015  |

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

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**L-1 IDENTITY SOLUTIONS, INC.  
Notes to Condensed Consolidated Financial Statements  
(Unaudited)**

**1. DESCRIPTION OF BUSINESS**

**Operations**

L-1 Identity Solutions, Inc. and its subsidiaries ( L-1 or the Company ) provide solutions and services that protect and secure personal identities and assets and allow international governments, federal and state agencies, law enforcement and commercial businesses to guard the public against terrorism, crime and identity theft.

In January 2010, L-1 announced that one of its strategic goals and objectives for 2010 was to explore strategic alternatives to enhance shareholder value. Subsequently, on September 19, 2010, the Company entered into an agreement (the Merger Agreement ) with Safran SA ( Safran ) and Laser Acquisition Sub Inc. ( Merger Sub ), a wholly owned subsidiary of Safran, pursuant to which, subject to the terms and conditions set forth in the Merger Agreement, the Company is to be acquired by Safran in a merger transaction providing for shareholders to receive \$12.00 per share in cash, for an aggregate enterprise value of approximately \$1.6 billion, inclusive of outstanding debt. See Note 3 to our consolidated financial statements for additional information. Completion of the merger remains subject to certain conditions, including, among others, (i) the disposition of our SpecTal/McClendon and Advanced Concepts businesses as described below; (ii) approval of the merger transaction by our shareholders; (iii) the expiration or termination of the applicable waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (the HSR Act ); (iv) termination or expiration of the Committee on Foreign Investment in the United States ( CFIUS ) review period pursuant to the Exon-Florio Provision of the Defense Production Act of 1950; (v) completion of the novation, termination or expiration of certain contracts; (vi) no Company Material Adverse Effect (as defined in the Merger Agreement) having occurred since the date of the Merger Agreement; (vii) subject to certain materiality exceptions, the accuracy of the representations and warranties made by the Company and Safran and compliance by the Company and Safran with their respective obligations under the Merger Agreement; (viii) no law or government order prohibiting the merger; and (ix) other customary conditions.

Also on September 19, 2010, the Company entered in a definitive agreement (the BAE Purchase Agreement ) to sell SpecTal/McClendon and Advanced Concepts (the Intel Business ) to BAE Systems Information Solutions, Inc. ( BAE ) (a subsidiary of BAE Systems, Inc. the U.S. affiliate of BAE Systems plc) for a purchase price of \$295.8 million in cash (and approximately \$7.2 million in assumed obligations), the net proceeds of which (as defined in the credit agreement) will be used to repay outstanding debt under the Company s credit agreement. Completion of the sale remains subject to certain conditions, including, among others, (i) the expiration or termination of the applicable waiting periods under the HSR Act; (ii) termination or expiration of the CFIUS review period; (iii) no Business Material Adverse Effect (as defined in the BAE Purchase Agreement) having occurred since the date of the BAE Purchase Agreement; (iv) subject to certain materiality exceptions, the accuracy of the representations and warranties made by the Company and BAE and compliance by the Company and BAE with their respective obligations under the BAE Purchase Agreement; (v) the completion of certain actions in respect of organizational conflict of interest provisions under certain contracts of the Intel Business; (vi) no law or judgment prohibiting the sale and (vii) other customary conditions. The purchase price is subject to adjustment based upon the working capital of the Intel Business at closing.

The accompanying financial statements reflect the impact of the sale of the Intel Business and approximately \$11.2 million of costs incurred related to exploration of strategic alternatives in respect of the nine months ended September 30, 2010, of which \$3.3 million is attributable to the Intel Business.

The operating results related to the Intel Business have been reflected as discontinued operations for all periods presented. Unless otherwise noted, revenues and expenses in these Notes to Condensed Consolidated Financial Statements exclude amounts attributable to discontinued operations. The assets and liabilities have been included in assets held for sale and liabilities related to assets held for sale at September 30, 2010.

The Company operates in two reportable segments: Solutions and Services. The Solutions segment includes Secure Credentialing and Biometrics/Enterprise Access. Secure Credentialing solutions span the entire secure credentialing lifecycle, from testing through issuance and inspection. This includes driver s licenses, national IDs, ePassports and

other forms of government-issued proof of identity credentials. Biometric solutions capture, manage and move biometric data for positive, rapid ID and tracking of persons of interest. Biometrics solutions also encompass access control readers that enable businesses and governments to secure facilities and restricted areas by preventing unauthorized entry.

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Prior to September 19, 2010, the Services segment included Enrollment Services, SpecTal/McClendon and Advanced Concepts. Enrollment Services performs fingerprint-based background checks necessary for federal and state licensed employment in the banking, finance, insurance, healthcare, legal, real estate, education and other industries. SpecTal/McClendon and Advanced Concepts provide services to the national security and intelligence community, including information technology, engineering and analytics, and intelligence. As a result of accounting for SpecTal/McClendon and Advanced Concepts as discontinued operations, subsequent to September 19, 2010, the Services segment consists of the Enrollment Services operating segment and all prior period segment data have been revised accordingly.

Customers, depending on their needs, may order solutions that include hardware, equipment, consumables, software products or services or combine hardware products, consumables, equipment, software products and services to create multiple element arrangements.

***Reorganization***

On May 16, 2007, the Company adopted a new holding company organizational structure to facilitate the issuance of its convertible senior notes (the Convertible Notes or Notes ) and the structuring of acquisitions. Pursuant to the reorganization, L-1 Identity Solutions, Inc. became the sole shareholder of its predecessor, L-1 Identity Solutions Operating Company ( L-1 Operating , previously also known as L-1 Identity Solutions, Inc.).

The Company has no operations other than those carried through its investment in L-1 Operating and the financing operations related to the issuance of the Convertible Notes. A summary balance sheet of the Company (Parent Company only) is set forth below (in thousands):

|                             | <b>September<br/>30,<br/>2010</b> | <b>December<br/>31,<br/>2009</b> |
|-----------------------------|-----------------------------------|----------------------------------|
| Assets:                     |                                   |                                  |
| Deferred financing costs    | \$ 1,693                          | \$ 2,506                         |
| Investment in L-1 Operating | 903,656                           | 894,988                          |
|                             | \$ 905,349                        | \$ 897,494                       |
| Liabilities and equity:     |                                   |                                  |
| Accrued interest            | \$ 2,466                          | \$ 825                           |
| Deferred tax liability      | 5,200                             | 5,200                            |
| Convertible debt            | 165,190                           | 161,008                          |
|                             | 172,856                           | 167,033                          |
| Equity                      | 732,493                           | 730,461                          |
|                             | \$ 905,349                        | \$ 897,494                       |

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES*****Basis of Presentation and Principles of Consolidation***

The accompanying unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments that in the opinion of management are necessary for a fair presentation of the financial statements for the interim periods. The unaudited condensed consolidated financial statements have been prepared in accordance with the regulations of the Securities and Exchange Commission ( SEC ) for interim financial statements, and in accordance with SEC rules, omit or condense certain information and footnote disclosures. Results for the interim periods are not necessarily indicative of results to be expected for any other interim period or for the

full year. These financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company's Annual Report on Form 10-K filed on February 26, 2010. The condensed consolidated financial statements include the accounts of L-1 and its wholly-owned subsidiaries, after elimination of material inter-company transactions and balances.



**Table of Contents***Use of Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The most significant assumptions and estimates relate to the allocation of the purchase price of the acquired businesses, assessing the impairment of goodwill, other intangible assets and property and equipment, revenue recognition, estimating the useful life of long-lived assets, inventory valuation allowance, provision for bad debts, income taxes, litigation and valuation of and accounting for financial instruments, including Convertible Notes, interest rate protection agreements, foreign currency contracts, warrants and stock options. Actual results could differ materially from those estimates.

*Revenue Recognition*

The Company derives its revenue from sales of solutions that include hardware components, consumables and software components and related maintenance, technical support, training and installation services integral to sales of hardware and software. The Company also derives revenues from sales of fingerprint based background check enrollment services and government security and information technologies services. A customer, depending on its needs, may order solutions that include hardware, equipment, consumables, software products or services or combine these products and services to create a multiple element arrangement. The Company's revenue recognition policies are described in the notes to the consolidated financial statements included in the Company's Annual Report on Form 10-K filed on February 26, 2010. There have been no material changes to such policies.

*Stock-Based Compensation*

L-1 uses the Black-Scholes valuation model to estimate the fair value of option awards. The following weighted average assumptions were utilized in the valuation of stock options in 2010 and 2009:

|  | <b>Three Months Ended</b> |                  | <b>Nine Months Ended</b> |                  |
|--|---------------------------|------------------|--------------------------|------------------|
|  | <b>September</b>          | <b>September</b> | <b>September</b>         | <b>September</b> |
|  | <b>30,</b>                | <b>30,</b>       | <b>30,</b>               | <b>30,</b>       |
|  | <b>2010</b>               | <b>2009</b>      | <b>2010</b>              | <b>2009</b>      |
| Expected common stock price volatility | 55.0%                     | 60.6%            | 56.2%                    | 59.3%            |
| Risk free interest rate                | 2.4%                      | 3.9%             | 3.3%                     | 3.9%             |
| Expected life of options               | 6.3 Years                 | 6.3 Years        | 6.3 Years                | 6.3 Years        |
| Expected annual dividends              |                           |                  |                          |                  |

The expected volatility rate is based on the historical volatility of the Company's common stock. The expected life of options are calculated pursuant to the relevant guidance from Staff Accounting Bulletin No. 107. The Company estimates forfeitures based on historical rates. The risk free interest rate is based on the applicable treasury security whose term approximates the expected life of the options. The Company updates these assumptions on at least an annual basis and on an interim basis if significant changes to the assumptions are determined to be necessary.

*Computation of Net Income (Loss) per Share*

Basic net income (loss) per share is calculated by using the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share is based upon the weighted average number of diluted shares outstanding during the period.

The weighted average number of shares of common stock outstanding during 2009, includes 1.1 million shares issuable pursuant to the Series A Convertible Preferred Stock before their conversion into common stock. Restricted share awards are included in the calculation of weighted average shares outstanding beginning on the date of vesting. The impact of approximately 1.9 million and 1.5 million of common equivalent shares for the three and nine month periods ended September 30, 2010, respectively, and the impact of 1.1 million and 0.5 million common equivalent shares for three and nine month periods ended September 30, 2009, respectively, were not reflected in the net income (loss) attributable to L-1's shareholders per share as their effect would be anti-dilutive.

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The Company calculates the effect of the Convertible Notes on diluted net income (loss) attributable to L-1 shareholders per share utilizing the as if converted method since the Company has the right to issue shares of common stock to settle the entire obligation upon conversion. For the three and nine month periods ended September 30, 2010 and 2009, the effect was anti-dilutive. Accordingly, approximately 5.5 million shares of weighted average common stock issuable at conversion have been excluded from the determination of weighted average diluted shares outstanding.

In connection with the issuance of the Convertible Notes, the Company entered into a pre-paid forward contract with Bear Stearns (now JP Morgan Chase) for a payment of \$69.8 million to purchase 3.5 million shares of the Company's common stock at a price of \$20.00 per share for delivery in 2012. The number of shares to be delivered under the contract is used to reduce weighted average basic and diluted shares outstanding for net income (loss) per share purposes.

*Adoption of New Accounting Standards*

Effective January 1, 2010, the Company adopted the following accounting standards:

In June 2009, the FASB issued the standard, *Amendments to FASB Interpretation No. 46(R)*. The standard changes the criteria to determine how an investee for a company is insufficiently capitalized or is not controlled through voting (or similar rights) and therefore should be consolidated. The adoption of this standard did not have a material impact on the financial statements for any of the periods presented.

In January 2010, the FASB issued the standard, *Fair Value Measurements and Disclosures - Improving Disclosures about Fair Value Measurements*. The adoption of this standard did not have a material impact on the financial statements for any of the periods presented.

*Recently Issued Accounting Standards*

In October 2009, the FASB issued the standard, *Multiple Element Arrangements*, which modifies accounting for multiple element arrangements by requiring that the separation of the arrangements be based on estimated selling prices based on entity specific assumptions rather than fair value, eliminating the residual method of allocation and requiring additional disclosures related to such arrangements. The standard is effective prospectively for arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. The Company has not yet evaluated the impact the adoption of the standard will have on its consolidated financial statements.

Also in October 2009, the FASB issued the standard, *Certain Revenue Arrangements That Include Software Elements*, which amends software revenue recognition guidance to eliminate from its scope tangible products containing software components that function together to deliver the tangible product's essential functionality and to provide guidance on how to allocate arrangement consideration to deliverables in an arrangement that contain both tangible products and software. The standard is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. The Company has not yet evaluated the impact the adoption of the standard will have on its consolidated financial statements.

**3. DISCONTINUED OPERATIONS**

On September 19, 2010, the Company has entered into an agreement to be acquired by Safran, in a merger transaction providing for L-1 shareholders to receive \$12.00 per share in cash, for an aggregate enterprise value of approximately \$1.6 billion, inclusive of outstanding debt. The Safran merger is conditioned on, among other things, the consummation of the BAE transaction described below.

Also on September 19, 2010, BAE agreed to acquire the stock and membership interests of the entities comprising the L-1 intelligence services businesses for a purchase price of approximately \$295.8 million in cash and approximately \$7.2 million of assumed obligations. These businesses include SpecTal, LLC, Advanced Concepts, Inc., and McClendon, LLC. The BAE transaction remains subject, among other conditions, to certain U.S. regulatory clearances, and is expected to close in the fourth quarter of 2010. The Company is required to use the net cash proceeds (as defined in the Company's credit agreement) from the closing of the BAE transaction to repay a substantial portion of the Company's indebtedness under its credit facility. The purchase price is subject to adjustment based on the Intel Business working capital at closing. It is expected that the sale of the intelligence services businesses will result in a gain which will be recorded upon consummation of the sale.



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The Safran and BAE transactions are not subject to financing. The closing of the Safran merger is conditioned on the closing of the BAE transaction; however, the closing of the BAE transaction is not conditioned on the closing of the Safran merger.

The major classes of assets and liabilities that are included as part of the intelligence services business (and presented as held for sale at September 30, 2010) are included in the table below. The December 31, 2009 amounts have not been reclassified as assets held for sale. (in thousands)

|   | <b>September<br/>30,<br/>2010</b> | <b>December<br/>31,<br/>2009</b> |
|---|-----------------------------------|----------------------------------|
| <b>Assets</b>                               |                                   |                                  |
| Cash  | \$                                | \$ 370                           |
| Accounts receivable, net                    | 34,335                            | 40,319                           |
| Other current assets                        | 1,446                             | 2,291                            |
| Property and equipment, net                 | 382                               | 458                              |
| Goodwill and intangible assets, net         | 226,353                           | 229,383                          |
| Other assets                                | 124                               | 124                              |
| <br>Total current assets held for sale      | <br>\$ 262,640                    | <br>\$ 272,945                   |
| <b>Liabilities</b>                          |                                   |                                  |
| Accounts payable and accrued expenses       | \$ 22,680                         | \$ 23,250                        |
| Other current liabilities                   | 894                               | 34                               |
| Deferred tax liability                      | 13,422                            | 14,016                           |
| Other liabilities                           | 5                                 | 44                               |
| <br>Total current liabilities held for sale | <br>\$ 37,001                     | <br>\$ 37,344                    |

The Company expects to recognize a gain on the sale of the Intel Business ranging from \$40.0 million to \$50.0 million pre-tax, depending on the net assets of the business at the date of closing.

A summary of the results of operations of the discontinued operations follows (in thousands):

|   | <b>Three Months Ended<br/>September<br/>30,<br/>2010</b> | <b>September<br/>30,<br/>2009</b> | <b>Nine Months Ended<br/>September<br/>30,<br/>2010</b> | <b>September<br/>30,<br/>2009</b> |
|---|--|-----------------------------------|---|-----------------------------------|
| Revenues                                | \$ 54,877  | \$ 53,305                         | \$ 164,610  | \$ 160,644                        |
| Cost of sales                           | 38,956   | 37,803                            | 117,148   | 113,795                           |
| Operating expenses                      | 10,727   | 9,780                             | 32,923  | 30,190                            |
| <br>Operating income                    | <br>5,194  | <br>5,722                         | <br>14,539  | <br>16,659                        |
| Interest expense                        | 6,169  | 8,013                             | 17,956  | 20,851                            |
| Strategic alternative transaction costs | 3,328  |                                   | 3,328   |                                   |
| Other income (expense)                  | 26   | (65)                              | 51  | (111)                             |
| <br>Loss before income taxes            | <br>(4,277)  | <br>(2,356)                       | <br>(6,694)   | <br>(4,303)                       |
| Benefit for income taxes                | 1,672  | 689                               | 2,240   | 1,596                             |

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|                                       |            |            |            |            |
|---------------------------------------|------------|------------|------------|------------|
| Net loss from discontinued operations | \$ (2,605) | \$ (1,667) | \$ (4,454) | \$ (2,707) |
|---------------------------------------|------------|------------|------------|------------|

Effective on September 19, 2010, the Company ceased recording depreciation and amortization of long-lived assets related to the discontinued operations. Included in discontinued operations is interest expense related to the estimated debt that is required to be repaid from the net proceeds of the sale of the business in accordance with the terms of our credit agreement. Interest has been allocated to discontinued operations based on the ratio that the estimated debt to be repaid bears to the total average debt outstanding during the period. Strategic alternative transaction costs attributed in discontinued operations represent costs incurred in connection with the sale of the Intel Business.

**Table of Contents****4. ADDITIONAL FINANCIAL INFORMATION****Inventory, net**

Inventory comprised the following as of September 30, 2010 and December 31, 2009, net of write downs of \$2.7 million and \$3.2 million, respectively (in thousands):

|                               | <b>September<br/>30,<br/>2010</b> | <b>December<br/>31,<br/>2009</b> |
|-------------------------------|-----------------------------------|----------------------------------|
| Purchased parts and materials | \$ 25,359                         | \$ 23,107                        |
| Work in progress              | 3,213                             | 615                              |
| Inventoried contract costs    | 3,113                             | 3,193                            |
| Finished goods                | 3,293                             | 2,469                            |
| Total Inventory               | \$ 34,978                         | \$ 29,384                        |

Approximately \$1.5 million and \$2.1 million of inventory at September 30, 2010 and December 31, 2009, respectively, were held at customer sites.

**Property and Equipment, net** (in thousands):

|  | <b>September<br/>30,<br/>2010</b> | <b>December<br/>31,<br/>2009</b> |
|--|-----------------------------------|----------------------------------|
| System assets                              | \$ 139,111                        | \$ 92,753                        |
| Computer and office equipment              | 11,909                            | 9,147                            |
| Machinery and equipment                    | 22,965                            | 23,107                           |
| Construction in progress                   | 25,899                            | 53,436                           |
| Leasehold improvements                     | 8,032                             | 7,652                            |
| Other including tooling and demo equipment | 4,596                             | 4,234                            |
|  | 212,512                           | 190,329                          |
| Less, accumulated depreciation             | 90,414                            | 74,829                           |
| Property and equipment, net                | \$ 122,098                        | \$ 115,500                       |

At September 30, 2010, property and equipment of \$0.4 million, net of accumulated depreciation of \$0.9 million was included in assets held for sale in the accompanying balance sheet.

Capital expenditures for the nine months ended September 30, 2010 and 2009 aggregated \$32.6 million and \$38.4 million, respectively, and include capitalized interest for the three and nine months ended September 30, 2010 and 2009 of \$0.4 million and \$1.5 million and \$0.4 million and \$1.0 million, respectively. These expenditures are principally related to the Solutions segment.

Depreciation expense on property and equipment for the three and nine months ended September 30, 2010 and 2009 was \$7.5 million and \$20.5 million and \$5.6 million and \$17.1 million. Approximately, \$0.1 million and \$0.2 million and \$0.1 million and \$0.2 million of depreciation expense for the three and nine months ended September 30, 2010 and 2009, respectively, has been included in discontinued operations.

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During the third quarter of 2010, the Company and the operator of the restarted Registered Traveler program were unable to negotiate mutually acceptable terms related to the Company's participation in the program. Accordingly, the Company determined that the assets designated for the program were impaired and recorded an impairment of \$2.9 million.

The following table presents depreciation and amortization expense excluding amortization of acquisition related intangible assets, but including amortization of other intangible assets, as reflected in continuing operations (in thousands):

|                            | <b>Three Months Ended</b>         |                                   | <b>Nine Months Ended</b>          |                                   |
|----------------------------|-----------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|
|                            | <b>September<br/>30,<br/>2010</b> | <b>September<br/>30,<br/>2009</b> | <b>September<br/>30,<br/>2010</b> | <b>September<br/>30,<br/>2009</b> |
| Cost of revenues           | \$ 7,525                          | \$ 5,652                          | \$ 20,590                         | \$ 16,847                         |
| Sales and marketing        | 88                                | 76                                | 272                               | 212                               |
| Research and development   | 175                               | 110                               | 438                               | 317                               |
| General and administrative | 991                               | 884                               | 2,972                             | 2,477                             |
|                            | <b>\$ 8,779</b>                   | <b>\$ 6,722</b>                   | <b>\$ 24,272</b>                  | <b>\$ 19,853</b>                  |

**Goodwill** (in thousands):

The following summarizes the activity in goodwill for the nine months ended September 30, 2010:

|  | <b>Solutions</b> | <b>Services</b> | <b>Total</b> |
|--|------------------|-----------------|--------------|
| Balance, January 1, 2010                 | \$ 626,499       | \$ 263,315      | \$ 889,814   |
| Reclassification to assets held for sale |                  | (188,589)       | (188,589)    |
| Currency translation adjustments         | (587)            | 130             | (457)        |
| Balance, September 30, 2010              | \$ 625,912       | \$ 74,856       | \$ 700,768   |

As of September 30, 2010, approximately \$149.0 million of goodwill was deductible for income tax purposes, of which \$101.0 million is included in assets held for sale. Goodwill reflects accumulated impairment charges of approximately \$430.0 million as a result of the charge recorded in 2008, principally related to the Solutions segment.

**Intangible Assets, net** (in thousands):

Intangible assets, net comprise the following as of September 30, 2010 and December 31, 2009:

|   | <b>September 30, 2010</b> |                                     | <b>December 31, 2009</b> |                                     |
|---|---------------------------|-------------------------------------|--------------------------|-------------------------------------|
|   | <b>Cost</b>               | <b>Accumulated<br/>Amortization</b> | <b>Cost</b>              | <b>Accumulated<br/>Amortization</b> |
| Acquisition related intangibles assets: |                           |                                     |                          |                                     |
| Completed technology                    | \$ 16,407                 | \$ (6,931)                          | \$ 14,425                | \$ (4,853)                          |
| Core technology                         | 340                       | (130)                               | 340                      | (79)                                |
| Trade names, trademarks and other       | 1,176                     | (688)                               | 7,263                    | (2,269)                             |
| Customer contracts and relationships    | 56,163                    | (21,404)                            | 104,063                  | (31,382)                            |
|   | 74,086                    | (29,153)                            | 126,091                  | (38,583)                            |
| Other intangible assets                 | 26,934                    | (10,094)                            | 23,591                   | (8,724)                             |
|   | <b>\$ 101,020</b>         | <b>\$ (39,247)</b>                  | <b>\$ 149,682</b>        | <b>\$ (47,307)</b>                  |

At September 30, 2010, intangible assets of \$37.8 million, net of accumulated amortization of \$16.4 million was included in assets held for sale in the accompanying balance sheet. As of September 30, 2010, approximately \$60.3 million of intangible assets, net were deductible for income tax purposes, of which \$27.7 million are included in assets held for sale.

Amortization of acquisition related intangible assets for the three and nine months ended September 30, 2010 and 2009, was \$1.3 million and \$3.9 million and \$1.3 million and \$4.1 million, respectively. Other intangible asset amortization excluding acquisition related amortization was \$1.3 million and \$3.8 million and \$1.1 million and \$2.7 million for the three and nine months ended September 30, 2010 and 2009, respectively. Approximately, \$0.8 million and \$3.0 million of amortization of acquisition related intangible assets for the three and nine months ended September 30, 2010 and \$1.1 million and \$3.3 million for the three and nine months ended September 30, 2009, respectively, are included in discontinued operations.

The following summarizes amortization of acquisition related intangible assets included in the continuing operations (in thousands):

|                  | <b>Three Months Ended</b> |                  | <b>Nine Months Ended</b> |                  |
|------------------|---------------------------|------------------|--------------------------|------------------|
|                  | <b>September</b>          | <b>September</b> | <b>September</b>         | <b>September</b> |
|                  | <b>30,</b>                | <b>30,</b>       | <b>30,</b>               | <b>30,</b>       |
|                  | <b>2010</b>               | <b>2009</b>      | <b>2010</b>              | <b>2009</b>      |
| Cost of revenues | \$ 1,334                  | \$ 1,260         | \$ 3,894                 | \$ 4,094         |



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Amortization of acquisition related intangible assets used in continuing operations for the current and subsequent four years and thereafter is as follows: \$1.3 million, \$4.9 million, \$4.2 million, \$3.8 million, \$2.0 million, and \$28.7 million, respectively.

**Financial Instruments**

The carrying amounts of accounts receivable, net, accounts payable and accrued expenses and other current liabilities approximate their fair values due to the short term maturities. The carrying amount of borrowings under the revolving credit agreement approximates fair value since the long-term debt bears interest at variable rates. The fair value of the Convertible Notes and Term Loan is based on market transaction prices. The fair value of interest rate protection agreements and foreign currency forward contracts are determined based on the estimated amounts that such contracts could be settled with the counterparty at the balance sheet date, taking into account current interest rates, future expectations of interest rates, and L-1's current credit worthiness. The recorded and estimated fair values are as follows for September 30, 2010 (in thousands):

|  | <b>Assets (Liabilities)</b>                                  |   |
|--|--|---|
|  | <b>Recorded<br/>amount at<br/>September<br/>30,<br/>2010</b> | <b>At<br/>Fair Value<br/>September<br/>30,<br/>2010</b> |
| Accounts Receivable  | \$ 89,596  | \$ 89,596   |
| Accounts Payable and Accrued Expenses, Excluding Interest Rate Protection<br>Agreements and Foreign Currency Forward Contracts | (86,361)   | (86,361)  |
| Other Current Liabilities  | (7,275)  | (7,275)   |
| Term Loans   | (266,655)  | (269,355)   |
| Revolving Credit Facility  | (35,000)   | (35,000)  |
| Convertible Notes  | (165,190)  | (174,781)   |
| Other Debt   | (1,222)  | (1,122)   |
| Derivatives:   |  |   |
| Foreign Currency Forward Contracts (included in accounts payable and<br>accrued expenses)                                      | (4)  | (4)   |
| Interest Rate Protection Agreements (included in accounts payable and<br>accrued expenses)                                     | (1,668)  | (1,668)   |

**Derivatives**

The Company is exposed to interest rate risk and foreign exchange risks that in part are managed by using derivative financial instruments. These derivatives include foreign currency forward contracts related to risks associated with foreign operations and interest protection agreements related to risks associated to variable rate borrowings. The Company does not use derivatives for trading purposes and at September 30, 2010, has no derivatives that are designated as fair value hedges.

Derivatives are recorded at their estimated fair values based upon Level 2 inputs. Derivatives designated and effective as cash flow hedges are reported as a component of other comprehensive income and reclassified to earnings in the same periods in which the hedged transactions impact earnings. Gains and losses related to derivatives not meeting the requirements of hedge accounting and the portion of derivatives related to hedge ineffectiveness are recognized in current earnings.

At September 30, 2010, the Company had outstanding foreign currency forward contracts denominated in Japanese Yen aggregating \$0.6 million. At December 31, 2009, the Company had outstanding foreign currency contracts denominated in Japanese Yen aggregating \$1.8 million.

The following summarizes certain information regarding the Company's derivative financial instruments (in thousands):

|   | <b>Balance Sheet<br/>Caption</b>        | <b>Fair Value at<br/>September 30,<br/>2010</b> | <b>December 31,<br/>2009</b> |
|---|---|---|------------------------------|
|   | Accounts<br>Payable/Accrued<br>Expenses |   |                              |
| Interest rate protection agreements   |   | \$ (1,668)                                      | \$ (1,896)                   |
| The following summarizes certain information regarding the Company's derivatives which have been designated and are effective as cash flow hedges (in thousands): |   |   |                              |

|                                     | <b>Recognized<br/>In OCI at<br/>September<br/>30, 2010</b> | <b>Three<br/>Months<br/>Ended<br/>September<br/>30, 2010</b> | <b>Gain (loss) reclassified from<br/>OCI to Income Statement<br/>Three<br/>Months<br/>Ended<br/>September<br/>30, 2009</b> | <b>Three<br/>Months<br/>Ended<br/>September<br/>30, 2010</b> | <b>Nine Months<br/>Ended<br/>September<br/>30, 2009</b> |
|-------------------------------------|--|--|--|--|---|
| Interest rate protection agreements | \$ (578)   | \$(133)  | \$ (133)   | \$ (400)   | \$ (356)  |
| Foreign currency contracts          |  |  | \$ 4   |  | \$ 37   |

The following summarizes certain information regarding the Company's derivatives that are not designated or are not effective as hedges (in thousands):

|                                     | <b>Income<br/>Statement<br/>Caption</b> | <b>Three<br/>Months<br/>Ended<br/>September<br/>30,<br/>2010</b> | <b>Three Months<br/>Ended<br/>September 30,<br/>2009</b> | <b>Nine Months<br/>Ended<br/>September<br/>30, 2010</b> | <b>Nine Months<br/>Ended<br/>September 30,<br/>2009</b> |
|-------------------------------------|---|--|--|---|---|
| Interest rate protection agreements | Interest Expense                        | \$ 99  | \$ (750)   | \$ 228  | \$ (518)  |
| Foreign currency forward contracts  | Other Expense, net                      | \$(39)   |  | \$ (85)   |   |

**Table of Contents****Products and Services Revenues:**

The following provides details of the products and services revenues included in continuing operations for the three and nine months ended September 30, 2010 and 2009 (in thousands):

|                                      | <b>Three Months Ended</b> |                  | <b>Nine Months Ended</b> |                  |
|--------------------------------------|---------------------------|------------------|--------------------------|------------------|
|                                      | <b>September</b>          | <b>September</b> | <b>September</b>         | <b>September</b> |
|                                      | <b>30,</b>                | <b>30,</b>       | <b>30,</b>               | <b>30,</b>       |
|                                      | <b>2010</b>               | <b>2009</b>      | <b>2010</b>              | <b>2009</b>      |
| Services:                            |                           |                  |                          |                  |
| U.S. Federal government services     | \$ 6,539                  | \$ 8,103         | \$ 19,938                | \$ 27,441        |
| State and local government services  | 24,900                    | 22,654           | 69,006                   | 57,085           |
| Total Services                       | 31,439                    | 30,757           | 88,944                   | 84,526           |
| Solutions:                           |                           |                  |                          |                  |
| State and local government solutions | 33,497                    | 30,622           | 91,585                   | 88,992           |
| Hardware and consumables             | 18,297                    | 31,492           | 58,661                   | 86,411           |
| Software, licensing fees and other   | 29,198                    | 17,618           | 58,282                   | 45,671           |
| Maintenance                          | 8,581                     | 8,744            | 26,137                   | 24,536           |
| Total Solutions                      | 89,573                    | 88,476           | 234,665                  | 245,610          |
| Total Revenues                       | \$ 121,012                | \$ 119,233       | \$ 323,609               | \$ 330,136       |

Services revenues included in continuing operations represent revenues from enrollment services contracts for which the Company is compensated based on volume of enrollments performed. Solutions revenues comprise revenues from the delivery of consumables and equipment, as well as hardware, software and systems that include related services, primarily maintenance, bundled with the related product deliverables. Because the product functionality is the primary deliverable for the customer, we have included the total revenues from these arrangements in solutions revenues. Solutions revenues also include revenues related to driver's license production contracts for which we provide systems and maintenance, produce the licenses and are compensated in one all inclusive price per license as the licenses are produced.

**Comprehensive Income (Loss) (in thousands):**

|  | <b>Three Months Ended</b> |                  | <b>Nine Months Ended</b> |                  |
|--|---------------------------|------------------|--------------------------|------------------|
|  | <b>September</b>          | <b>September</b> | <b>September</b>         | <b>September</b> |
|  | <b>30,</b>                | <b>30,</b>       | <b>30,</b>               | <b>30,</b>       |
|  | <b>2010</b>               | <b>2009</b>      | <b>2010</b>              | <b>2009</b>      |
| Net income (loss)                                  | \$ (9,175)                | \$ 1,372         | \$ (19,412)              | \$ (3,658)       |
| Changes in accumulated comprehensive income (loss) | 1,611                     | 963              | (52)                     | 1,769            |
| Comprehensive income (loss)                        | \$ (7,564)                | \$ 2,335         | \$ (19,464)              | \$ (1,889)       |

**5. RELATED PARTY TRANSACTIONS**

Aston Capital Partners, L.P. (Aston), an affiliate of L-1 Investment Partners LLC, owns approximately 8.2 percent of L-1's outstanding common stock. Mr. Robert LaPenta, Mr. James DePalma, Mr. Joseph Paresi and Ms. Doni Fordyce, each executive officers of the Company, directly and indirectly hold all the beneficial ownership in L-1 Investment Partners LLC and Aston Capital Partners GP LLC, the investment manager and general partner of Aston.

Mr. LaPenta is also the Chairman of the Board of Directors and Chief Executive Officer and President of the Company. Mr. DePalma is also the Chief Financial Officer and Treasurer of the Company.

Contemporaneously with the execution of the Merger Agreement described above, on September 19, 2010, Mr. LaPenta, Chairman, President and Chief Executive Officer of the Company, and Aston, entered into a voting and support agreement with Safran and Merger Sub. Pursuant to the voting and support agreement, Mr. LaPenta and Aston agreed, among other things, to vote their shares of our common stock in favor of the adoption of the Merger Agreement and approval of the merger, unless the Company's board of directors changes its recommendation of the merger to shareholders (in which case, Mr. LaPenta and Aston may vote for or against the merger).

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In December 2005, Aston completed a \$100 million investment and became the beneficial owner of L-1's common stock. The investment agreement provides Aston with a right of first refusal to purchase a pro rata of new securities issued by L-1, subject to specified terms.

On August 5, 2008, Mr. Robert LaPenta purchased 750,000 shares of L-1 common stock and 15,107 shares of Series A Convertible Preferred Stock, par value \$0.001 per share ( Series A Preferred Stock ) which in accordance with its terms was converted to 1,310,992 shares of common stock in 2009.

In connection with the merger with Identix, Aston and L-1 agreed in principle that the Company may, subject to approval of the Company's Board of Directors, purchase AFIX Technologies, Inc. ( AFIX ) a portfolio company of Aston, which provides fingerprint and palmprint identification software to local law enforcement agencies, at fair market value to be determined by an independent appraiser retained by the Company's Board of Directors. A committee of the Board of Directors was appointed to evaluate a potential transaction. In March 2009, L-1 concluded that due to a variety of factors, it was not advisable to pursue the transaction with AFIX at that point in time. Receivables from AFIX at September 30, 2010 and 2009 were \$0.2 million and \$0.1 million, respectively. Sales to AFIX for the three and nine month period ended September 30, 2010 were less than \$0.1 million and \$0.2 million, respectively, and less than \$0.1 million and \$0.1 million for the same period in the prior year.

In connection with the relocation of the corporate headquarters of the Company in the third quarter of 2006 to the offices of L-1 Investment Partners LLC in Stamford, Connecticut, the Company entered into a sublease with L-1 Investment Partners LLC under which the Company reimburses L-1 Investment Partners LLC for the rent and other costs payable by the Company. On June 29, 2009, the sublease was extended until March 2015. For the three and nine months ended September 30, 2010, the Company incurred costs of \$0.2 million and \$0.5 million, respectively, and \$0.2 million and \$0.6 million for the same period in the prior year, related to the sublease agreement.

The Company has employment and non-competition agreements with all of its executive officers. Such agreements provide for employment and related compensation and restrict the individuals from competing with the Company. The agreements also provide for the grant of stock options under the Company's stock option plans and for severance upon termination under circumstances defined in such agreements.

As a condition to the closing of the 2006 merger between the Company and Identix Incorporated ( Identix ), the Company and L-1 Investment Partners LLC entered into a Termination and Noncompete Agreement which, among other things, (1) terminated all arrangements whereby L-1 Investment Partners LLC and its affiliates provided financial, advisory, administrative or other services to the Company or its affiliates, and (2) prohibits L-1 Investment Partners LLC and its affiliates from engaging or assisting any person that competes directly or indirectly with the Company in the business of biometric, credentialing and ID management business anywhere in the United States or anywhere else in the world where the Company does business, or plans to do business or is actively evaluating doing business during the restricted period; provided however that the foregoing does not restrict L-1 Investment Partners LLC and its affiliates from retaining its investment in and advising AFIX Technologies, Inc. The restricted period runs co-terminously with the term of Mr. LaPenta's employment agreement with the Company, dated as of August 29, 2006, and for a twelve month period following the expiration of the term of Mr. LaPenta's employment agreement. On April 23, 2007, the Company entered into an employee arrangement with Mr. Robert LaPenta, Jr., the son of the Company's Chief Executive Officer, to serve as Vice President, M&A/Corporate Development.

The Company has consulting agreements with Mr. Denis K. Berube, a former member of the Company's Board of Directors, and his spouse, Ms. Joanna Lau, under which each receives annual compensation of \$0.1 million. Each agreement terminates on the earlier of January 10, 2012, or commencement of full time employment elsewhere. Under the terms of a 2002 acquisition agreement with Lau Security Systems, an affiliate of Mr. Berube and Ms. Lau, the Company is obligated to pay Lau a royalty on certain of its face recognition revenues through June 30, 2014, up to a maximum of \$27.5 million. The estimated royalty costs incurred for the three and nine months ended September 30, 2010 amounted to approximately less than \$0.1 million and \$0.1 million, respectively, and less than \$0.1 million for the same periods in the prior year.

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On February 26 and February 28, 2010, the Company entered into an engagement letter with each of Goldman Sachs & Co. ( Goldman ) and Stone Key Partners LLC and Hudson Partners Securities LLC ( Stone Key ), pursuant to which they are acting as financial advisors to the Company in connection with the Company's exploration of strategic alternatives to enhance shareholder value. Both Goldman and Stone Key were selected after a competitive evaluation process involving multiple prospective advisors. In connection with their respective engagements, Goldman and Stone Key are entitled to receive customary fees from the Company. These fees, a substantial portion of which are payable in the event a transaction or transactions are consummated, would be allocated approximately 58% to Goldman and 42% to Stone Key. The aggregate transaction fee payable to the advisors would be 1.2% of the transaction value of which 15% was earned upon the delivery of the fairness opinions and the signing of a definitive transaction agreements, which occurred on September 19, 2010. Accordingly, the Company recorded aggregate liabilities for transaction fees and expenses of \$3.0 million of which \$1.3 million is due to Stone Key. The remainder would be earned upon closing of the Safran and BAE transactions. In addition, Stone Key would be entitled to a reduced fee if the Company receives a break up fee or similar payment in connection with the termination of a signed transaction agreement. Similar features apply to the Goldman engagement fee structure and the Company believes such arrangements are customary. Upon successful completion of the merger transaction with Safran described above, the Company will pay Stone Key and Goldman estimated aggregate transaction fees of \$18.9 million of which \$7.9 million is payable to Stone Key.

Michael J. Urfirer, is a co-owner and co-founder of Stone Key's parent company, is Co-Chairman and Co-CEO of Stone Key, and is also the husband of Doni L. Fordyce, our Executive Vice President of Corporate Communications. Mr. Urfirer has confirmed to the Company that he has no specific interest in any fees paid to Stone Key attributable to his status as co-owner of Stone Key and its affiliates or otherwise. He will not receive any commission, direct participation or similar payment in connection with Stone Key's receipt of any fees. In his capacity as an employee of Stone Key's parent company, Stone Key Group LLC (SKG), Mr. Urfirer receives a salary from SKG which is not based on fees. In addition, in his capacity as the holder of an interest in SKG, Mr. Urfirer is entitled to a percentage of SKG's profits. The profits interest in SKG held by Mr. Urfirer is not a fixed percentage and will vary based on the revenues and expenses of SKG, the operation of payment priorities in SKG's LLC Agreement and potential future dilution. Under certain scenarios, Mr. Urfirer's interest in SKG's 2010 profits could be equal to but will in no event exceed 50% and therefore, Mr. Urfirer's share of the fee could approximate \$4.0 million, before considering related operating costs and expenses.

Mr. Urfirer and Stone Key's other Co-Chairman and Co-CEO hold personal investments in Aston Capital Partners, L.P. as minority limited partners. Certain of our executive officers, including Mr. LaPenta, Mr. DePalma, Mr. Paresi and Ms. Fordyce, control Aston Capital Partners, L.P. through their ownership interest in the general partner.

**6. LONG-TERM DEBT AND FINANCING ARRANGEMENTS**

Long-term debt consists of the following (in thousands):

|   | <b>September<br/>30,<br/>2010</b> | <b>December<br/>31,<br/>2009</b> |
|---|-----------------------------------|----------------------------------|
| \$175.0 million aggregate principal amount 3.75 percent Convertible Senior Notes due May 15, 2027 | \$ 175,000                        | \$ 175,000                       |
| Borrowings under revolving credit agreement   | 35,000                            | 4,868                            |
| Borrowings under term loan  | 269,005                           | 282,056                          |
| Capital leases and other  | 1,222                             | 1,611                            |
|   | 480,227                           | 463,535                          |
| Less: Unamortized discount on convertible notes   | 9,811                             | 13,991                           |
| Less: Unamortized original issue discount on term loan  | 2,350                             | 3,178                            |
| Less: Current portion of long-term debt   | 268,262                           | 27,062                           |

\$ 199,804 \$ 419,304

Pursuant to the terms of the Credit Agreement, as amended, as described below, the Company is required to use the Net Cash Proceeds (as defined) from the sale the Intel Business to BAE to reduce amounts borrowed under the Credit Agreement first in reduction to the Term Loans and next in reduction of revolving loans. The estimated Net Cash Proceeds, as defined, approximate \$270.0 million which exceeds the aggregate principal amounts of the Term Loans as of September 30, 2010. Because the related assets held for sale and corresponding liabilities are included in current assets and liabilities the total amount outstanding under the Term Loans, of \$269.0 million, net of original discount and \$1.0 million of borrowings under the revolving credit facility has been included in current liabilities. The related deferred financing costs are included in other assets. It is expected that upon this mandatory prepayment of the Term Loans, the Company will record a loss on the settlement of the debt.

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Excluding the effect of the mandatory prepayment described above, scheduled principal payments on long-term debt and financing arrangements for the subsequent four years are as follows: \$43.6 million, \$34.0 million, \$402.5 million and \$0.1 million. The Convertible Notes' final maturity date is 2027, but the holders have the right to require the Company to repurchase the Notes at par in 2012. The repayment schedule assumes that it will be repaid in 2012. The Term Loan's final maturity date is 2013, but must be repaid prior to the repayment of the Convertible Notes. Accordingly, the repayment schedules reflect the repayment in 2012.

**Credit Agreement**

On August 5, 2008, L-1 entered into a Second Amended and Restated Credit Agreement (the "Credit Agreement"), among L-1 Identity Operating, L-1, Bank of America, N.A., Wachovia Bank, National Association, Banc of America Securities LLC and Wachovia Capital Markets LLC, Royal Bank of Canada, Societe Generale and TD Bank, N.A. to amend and restate the Amended and Restated Credit Agreement, by and among L-1, Bank of America, N.A. ( "Administrative Agent" ), Bear Stearns Corporate Lending, Inc., Bear Stearns & Co., Inc., Banc of America Securities LLC, Wachovia Bank, N.A. and Credit Suisse, Cayman Islands Branch. The Credit Agreement provides for a senior secured term loan facility in an aggregate principal amount of up to \$300.0 million, with a term of five years, and a senior secured revolving credit facility in an aggregate principal amount of up to \$135.0 million. The proceeds of the senior secured facilities were used to (i) fund, in part, the purchase price paid, and fees and expenses incurred, in connection with L-1's acquisition of Digimarc Corporation after giving effect to the spin-off of its digital watermarking business ( "Old Digimarc" ), (ii) repay borrowings under L-1's existing revolving credit facility and (iii) provide ongoing working capital and fund other general corporate purposes of L-1. As of September 30, 2010, the Company has approximately \$92.0 million available under its revolving credit facility, subject to continuing compliance with the covenants contained in the agreement.

On July 9, 2009, L-1 entered into an amendment to the Credit Agreement pursuant to which the term loans under the Credit Agreement have been split into two tranches: the Tranche B-1 Term Loan and the Tranche B-2 Term Loan. The Tranche B-1 Term Loan, with an aggregate principal amount of approximately \$136.5 million at September 30, 2010, requires annual principal payments (payable quarterly) of 10 percent of the original principal amount through September 30, 2010, 20 percent of the original principal amount through September 30, 2012, and thereafter increasing over the duration of the Credit Agreement. The Tranche B-2 Term Loan, with an aggregate principal amount of approximately \$132.5 million at September 30, 2010, requires annual principal payments (also payable quarterly) of 1 percent of the related original principal amounts over the remaining term of the Credit Agreement. There were \$35.0 million of borrowings and \$8.0 million of letters of credit that were outstanding under the revolving credit facility, respectively, at September 30, 2010.

Under the terms of the amended senior secured credit facility, the Company has the option to borrow at LIBOR (subject to a floor of 3 percent) plus 2.75 percent to 5.0 percent per annum or at prime (subject to a floor of 2 percent) plus 1.75 percent to 4.0 percent per annum. L-1 is required to pay a fee of 0.5 percent on the unused portion of the revolving credit facility. All obligations of L-1 Operating under the Credit Agreement are guaranteed on a senior secured basis by L-1 and by each of L-1's existing and subsequently acquired or organized direct or indirect wholly-owned subsidiaries (subject to certain exceptions). At September 30, 2010, the interest rates were 6.75 percent for Tranche B-1 Term Loans, 7.25 percent for Tranche B-2 Term Loans and 6.0 percent for borrowings under the revolving credit facility.

L-1 is required to maintain the following financial covenants under the Credit Agreement:

**Consolidated Debt Service Coverage Ratio.** As of the end of any fiscal quarter, the ratio of Consolidated EBITDA (as defined in the Credit Agreement) of L-1 Operating and its consolidated subsidiaries for the period of four consecutive fiscal quarters ending on or immediately prior to such date to the sum of (i) Consolidated Interest Charges (as defined in the Credit Agreement) of L-1 Operating and its consolidated subsidiaries paid or payable in cash during the period of four consecutive fiscal quarters ended on or immediately prior to such date, plus (ii) Consolidated Debt Amortization (as defined in the Credit Agreement) of L-1 Operating and its consolidated subsidiaries as of such date, shall not be less than 2.25:1.00, subject to the amendment described below.



Consolidated Leverage Ratio. As of the end of any fiscal quarter, the ratio of L-1 Operating s Consolidated Funded Indebtedness (as defined in the Credit Agreement, which excludes standby letters of credit issued in connection with performance bonds) as of such date to its Consolidated EBITDA (as defined in the Credit Agreement) for the period of four consecutive fiscal quarters ended on or immediately prior to such date, may not be more than: (i) 3.25:1.00 from the Closing Date (as defined in the Credit Agreement) to and including March 31, 2010, (ii) 3.00:1.00 from March 31, 2010 to March 30, 2011, and (iii) 2.75:1.00 at the end of each fiscal quarter thereafter, which has been amended as described below.

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On August 30, 2010, L-1 entered into an amendment and consent (the "Third Amendment") to the Second Amended and Restated Credit Agreement dated as of August 5, 2008, among L-1 Identity Solutions Operating Company, the Company, Bank of America, N.A., the Lenders party thereto, Wachovia Bank, National Association, Banc of America Securities LLC and Wachovia Capital Markets LLC (as amended, the "Credit Agreement"). The Third Amendment extends the time period during which previously modified financial covenants will apply under the Credit Agreement, subject to the Company entering into definitive agreements providing for the sale of all or substantially all of the assets and operations of the Company and its subsidiaries in connection with its strategic alternatives review by September 30, 2010, which the Company executed on September 19, 2010. The Third Amendment provides that the minimum Consolidated Debt Service Coverage Ratio of 1.65 to 1.00 will remain in effect for the third fiscal quarter of 2010 and the period through and including March 30, 2011, after which the minimum Consolidated Debt Service Coverage Ratio shall return to 2.25 to 1.00 for each fiscal quarter thereafter, and the maximum Consolidated Leverage Ratio of 3.85 to 1.00 remain in effect for the third fiscal quarter of 2010 and the period through and including March 30, 2011, after which the maximum Consolidated Leverage Ratio shall return to 2.75 to 1.00 for each fiscal quarter thereafter. At September 30, 2010 the Company's Consolidated Debt Service Coverage Ratio was 2.00:1.00 and the Consolidated Leverage Ratio was 3.25:1.00; accordingly the Company was in compliance with the modified financial covenants.

Under the terms of the Credit Agreement, as amended, L-1 Operating may incur, assume or guarantee unsecured subordinated indebtedness in an amount up to \$200.0 million, provided that no default or event of default shall have occurred or would occur as a result of the incurrence of such subordinated debt and the borrower and its subsidiaries are in pro forma compliance, after giving effect to the incurrence of such subordinated debt, with each of the covenants in the Credit Agreement, including, without limitation, the financial covenants described above.

Pursuant to the terms of the Credit Agreement, as amended, L-1 may incur, assume or guarantee any amount of unsecured subordinated indebtedness, provided, that no default or event of default shall have occurred or would occur as a result of the incurrence of such subordinated debt and the pro forma Consolidated Leverage Ratio (as defined in the Credit Agreement) of L-1 and its subsidiaries after giving effect to the incurrence of such subordinated debt shall be less than 4.75:1.00. The Credit Agreement limits the ability of L-1 to (i) pay dividends or other distributions or repurchase capital stock, (ii) create, incur, assume or suffer to exist any indebtedness, (iii) create, incur, assume or suffer to exist liens upon any of its property, assets or revenues, (iv) sell, transfer, license, lease or otherwise dispose of any property, (v) make or become legally obligated to make capital expenditures above certain thresholds, subject to certain permitted adjustments, (vi) make investments, including acquisitions, and (vii) enter into transactions with affiliates. These covenants are subject to a number of exceptions and qualifications. The Credit Agreement provides for customary events of default which include (subject in certain cases to grace and cure periods), among others: nonpayment, breach of covenants or other agreements in the Credit Agreement or the other Loan Documents (as defined in the Credit Agreement), payment defaults or acceleration of other indebtedness, failure to pay certain judgments, inability to pay debts as they become due and certain events of bankruptcy, insolvency or reorganization.

If an event of default, including a change in control, occurs (as defined in the Credit Agreement), the Administrative Agent may, with the consent of the Required Lenders declare all outstanding indebtedness including accrued and unpaid interest under the Credit Agreement to be due and payable.

In October 2008, the Company entered into an interest rate protection agreement to reduce its exposure to the variable interest rate payments on its term loan. The interest rate protection agreement has a notional amount of \$62.5 million, and expires in November, 2011. Under the term of the agreement, the Company pays the counterparty a fixed rate of 4.1 percent and receives variable interest based on three-month LIBOR (subject to a floor of 3.0 percent). In May 2009, the Company entered into two additional interest rate protection agreements with notional amounts of \$50.0 million each pursuant to which the Company pays a fixed rate of 1.4 percent and receives three month LIBOR. The counterparties to the agreements are highly rated financial institutions. In the unlikely event that the counterparties fail to meet the terms of the interest rate swap agreement, the Company's exposure is limited to the interest rate differential on the notional amount at each quarterly settlement period over the life of the agreements. L-1 does not anticipate non-performance by the counterparties.

**Convertible Senior Notes**



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On May 17, 2007, the Company issued \$175.0 million of Convertible Notes with a conversion feature which allows the Company the option to settle the debt either in shares of common stock or to settle the principal amount in cash and the conversion spread in cash or common stock. The proceeds of the Convertible Notes offering, net of deferred financing costs amounted to \$168.7 million. The embedded conversion feature has not been deemed a derivative since the conversion feature is indexed to the Company's stock and would be classified as equity.

The Notes are governed by an indenture, dated May 17, 2007 (the "Indenture"), between the Company and The Bank of New York, as trustee. The Notes will be convertible only under certain circumstances, as described below. If, at the time of conversion, the daily volume-weighted average price per share for a 25 trading day period calculated in accordance with the Indenture (as defined in greater detail in the Indenture, "VWAP") of the Company's common stock is less than or equal to \$32.00 per share, which is referred to as the base conversion price, the Notes will be convertible into 31.25 shares of common stock of the Company per \$1,000 principal amount of the Notes, subject to adjustment upon the occurrence of certain events. If, at the time of conversion, the VWAP of the shares of common stock of the Company exceeds the base conversion price of \$32.00 per share, the conversion rate will be determined pursuant to a formula resulting in holders' receipt of up to an additional 14 shares of common stock per \$1,000 principal amount of the Notes, subject to adjustment upon the occurrence of certain events and determined as set forth in the Indenture.

The Notes are convertible until the close of business on the second business day immediately preceding May 15, 2027, in multiples of \$1,000 in principal amount, at the option of the holder under the following circumstances: (1) during the five business-day period after any five consecutive trading day period (the "measurement period") in which the trading price the Note, for each day of such measurement period was less than 98 percent of the product of the last reported sale price of shares of common stock of the Company and the applicable conversion rate for such trading day; (2) during any fiscal quarter, if the last reported sale price of shares of common stock of the Company for 20 or more trading days in a period of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter is greater than or equal to 130 percent of the base conversion price on the related trading day; (3) if the Company calls any or all of the Notes for redemption; and (4) upon the occurrence of specified corporate transactions described in the Indenture. Upon conversion, the Company has the right to deliver shares of common stock based upon the applicable conversion rate, or a combination of cash and shares of common stock, if any, based on a daily conversion value as described above calculated on a proportionate basis for each trading day of a 25 trading-day observation period. In the event of a fundamental change as specified in the Indenture, the Company will increase the conversion rate by a number of additional shares of common stock specified in the Indenture, or, in lieu thereof, the Company may in certain circumstances elect to adjust the conversion rate and related conversion obligation so that the Notes will become convertible into shares of the acquiring or surviving company. In connection with the Safran merger, the Company is required to deliver a conversion price notice no later than 35 days prior to the anticipated closing date. It is expected that the conversion price will be equal to the base conversion price. The Notes will not become convertible into shares of Safran in connection with the merger.

The Notes bear interest at a rate of 3.75 percent per year payable semiannually in arrears in cash on May 15 and November 15 of each year. The Notes will mature on May 15, 2027, unless earlier converted, redeemed or repurchased. The Company may redeem the Notes at its option, in whole or in part, on or after May 20, 2012, subject to prior notice as provided in the Indenture. The redemption price during that period will be equal to the principal amount of the Notes to be redeemed, plus any accrued and unpaid interest. The holders can require the Company to repurchase the Notes for cash on May 15, 2012, May 15, 2017 and May 15, 2020. The embedded redemption and repurchase provisions have not been separated from the host contracts and accounted for as derivatives because such embedded derivatives are deemed to be clearly and closely related to the host contract.

The Convertible Notes are structurally subordinated to all liabilities of L-1 Operating. Under the term of the Credit Agreement, as defined above, L-1 Operating may not make any dividend payment to the Company except to permit the Company to make scheduled interest payments on the subordinated debt up to a maximum of \$10.0 million per year, and certain tax liabilities. However, subject to certain prepayment requirements under the Credit Agreement, the Company may prepay, redeem or repurchase the Convertible Notes in amounts not in excess of proceeds from the issuance of additional equity securities of the Company.

Upon consummation of any share exchange, consolidation or merger of L-1 pursuant to which its common stock will be converted into cash, securities or other property or any sale, lease or other transfer in one transaction or a series of transactions of all or substantially all of L-1's and L-1's subsidiaries' assets, taken as a whole, to any person other than one of its subsidiaries, the holders of the Convertible Notes can convert the Notes or require the Company to repurchase all outstanding debt at a purchase price equal to 100 percent of the principal amount plus accrued and unpaid interest. It is expected that the holder of the Notes will exercise their rights to require the Company to purchase the Notes upon closing of the consummation of the merger of the Company with Safran.

**Table of Contents****7. EQUITY****Warrants**

In connection with the merger with Identix, the Company assumed Identix' obligation under a warrant which was issued in exchange for the technology and intellectual property rights acquired by Identix. The warrant was issued with contingent future vesting rights to purchase up to 378,400 shares of common stock at \$9.94 per share. The fair value of the warrant at the time of vesting will be recorded as additional cost of the acquisition of Identix. The warrant vests upon successful issuance of certain patents with the U.S. government related to the technology acquired. As of September 30, 2010, 141,900 warrants were vested of which 17,738 have been exercised, and 236,500 remain unvested. Subsequently, in October 2010, an additional 109,972 warrants were exercised. The warrants expire in 2014.

**Pre-paid Forward Contract**

In connection with the issuance of the Convertible Notes on May 17, 2007, the Company entered into a contract with Bear Stearns (subsequently acquired by JP Morgan Chase & Co.) to purchase 3,490,400 shares of the Company's common stock at a purchase price of \$20.00 per share. Under the agreement, Bear Stearns is required to deliver the shares to the Company in April-May 2012. At closing of the Convertible Notes, the Company settled its obligation under the pre-paid forward contract to Bear Stearns for cash of \$69.8 million. The fair value of the obligation (which is equal to the cash paid) has been accounted for as a repurchase of common stock and as a reduction of equity. Under terms of the contract, any dividend payment that Bear Stearns would otherwise be entitled to on the common stock during the term of the contract would be paid to the Company. The transaction is subject to early settlement or settlement with alternative consideration in the event of certain significant corporate transactions such as a change in control (which would include the consummation of the merger with Safran).

**Issuance of Equity Securities**

On August 5, 2008, pursuant to the terms and conditions of (i) the Securities Purchase Agreement, by and between L-1 and Robert V. LaPenta (the "LaPenta Agreement"), (ii) the Securities Purchase Agreement (the "Iridian Agreement"), by and between L-1 and Iridian Asset Management LLC ("Iridian") and (iii) the LRSR LLC Agreement (together with the LaPenta Agreement and Iridian Agreement, the "Investor Agreements"), L-1 issued an aggregate of 8,083,472 shares of L-1 common stock and 15,107 shares of Series A Convertible Preferred Stock (the "Series A Preferred Stock") for aggregate proceeds to L-1 of \$119.0 million, net of related issuance costs, which were used to fund a portion of L-1's acquisition of Old Digimarc. In accordance with its terms, the Series A Preferred Stock was converted to 1,310,992 shares of common stock in 2009.

**8. STOCK OPTIONS AND RESTRICTED STOCK AWARDS**

The following table summarizes the stock option activity from January 1, 2010 through September 30, 2010:

|  | <b>Stock<br/>Options</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price</b> | <b>Weighted<br/>Average<br/>Remaining<br/>Life<br/>(Years)</b> | <b>Aggregate<br/>Intrinsic<br/>Value</b> |
|--|--------------------------|--|--|--|
| Outstanding at January 1, 2010                   | 8,091,652                | \$ 13.56   |  |  |
| Granted  | 38,500                   | 8.09   |  |  |
| Exercised  | (207,242)                | 3.70   |  |  |
| Canceled/expired/forfeited                       | (704,118)                | 18.99  |  |  |
| Outstanding at September 30, 2010                | 7,218,792                | \$ 13.29   | 5.99   | \$ 9,875,494                             |
| Vested or expected to vest at September 30, 2010 | 5,637,877                | \$ 13.29   | 5.99   | \$ 7,712,761                             |
| Exercisable at September 30, 2010                | 5,228,456                | \$ 14.05   | 5.22   | \$ 4,616,590                             |



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Under the terms of the merger agreement with Safran SA, all options and restricted stock will vest at closing of the sale. The aggregate unearned compensation cost of unvested options outstanding as of September 30, 2010, was \$10.4 million and will be amortized over a weighted average period of 2.0 years. The total intrinsic value of options exercised during the three and nine months ended September 30, 2010 was \$0.9 million and \$1.3 million, respectively. The intrinsic value is calculated as the difference between the market value of the Company's common stock and the exercise price of options.

For the nine month period ending September 30, 2010, the Company awarded 419,787 shares of restricted stock to officers, directors and employees and had total outstanding restricted stock awards of 1,531,189 as of September 30, 2010. The restricted stock vests over four years and the weighted average grant date fair value was \$7.40 at September 30, 2010. At September 30, 2010, approximately 1,196,000 shares are expected to vest. Unearned compensation related to restricted stock that is expected to vest approximated \$6.3 million at September 30, 2010. Options and restricted stock expected to vest are determined by applying the pre-vesting forfeiture rate assumptions to total outstanding options and restricted stock.

Stock-based compensation expense was \$3.8 million and \$11.2 million and \$3.4 million and \$9.7 million for the three and nine months ended September 30, 2010 and 2009, respectively, and includes compensation expense related to restricted stock, stock options, employee purchases under the stock purchase plan, and Company retirement plan contributions settled or to be settled in common stock. The Company did not capitalize any stock compensation costs during any of the periods presented. Approximately, \$2.0 million and \$6.8 million of stock-based compensation expense for the three and nine months ended September 30, 2010, respectively, and \$2.0 million and \$6.5 million for the three and nine months ended September 30, 2009, respectively, are included in discontinued operations. The following table presents stock-based compensation expense included in continuing operations (in thousands):

|                            | <b>Three Months Ended</b>         |                                   | <b>Nine Months Ended</b>          |                                   |
|----------------------------|-----------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|
|                            | <b>September<br/>30,<br/>2010</b> | <b>September<br/>30,<br/>2009</b> | <b>September<br/>30,<br/>2010</b> | <b>September<br/>30,<br/>2009</b> |
| Cost of Revenues           | \$ 306                            | \$ 214                            | \$ 796                            | \$ 686                            |
| Research and Development   | 419                               | 402                               | 1,233                             | 1,369                             |
| Sales and Marketing        | 564                               | 595                               | 1,375                             | 1,553                             |
| General and Administrative | 2,552                             | 2,157                             | 7,836                             | 6,121                             |
|                            | \$ 3,841                          | \$ 3,368                          | \$ 11,240                         | \$ 9,729                          |

**9. LITIGATION***Putative Shareholder Class Action Litigation*

The Company has been named as a defendant in five putative shareholder class actions filed in the Superior Court of Connecticut, Judicial District of Stamford-Norwalk at Stamford, arising out of the proposed transactions with Safran and BAE pursuant to the Merger Agreement and BAE Purchase Agreement. The actions are captioned: *Michael Palma v. Robert LaPenta et al.*, CV-10-6006781-S (Conn. Super. Ct.), *Barry P. Kranz, Jr. v. L-1 Identity Solutions et al.*, CV-10-6006760-S (Conn. Super. Ct.), *Michael Matteo v. L-1 Identity Solutions et al.*, CV-10-6006759-S (Conn. Super. Ct.), *Dart Seasonal Products Retirement Plan v. L-1 Identity Solutions et al.*, CV-10-6006835-S (Conn. Super. Ct.), and *George F. Chrisman v. Robert LaPenta et al.*, CV-10-6006886-S (Conn. Super. Ct.) (collectively, the Shareholder Actions ).

The plaintiffs in the Shareholder Actions generally allege the members of the L-1 Board of Directors and certain officers of the Company breached their fiduciary duties to shareholders by, among other things, allegedly failing to receive maximum value for their shares, failing to conduct an appropriate sale process and agreeing to certain terms in the proposed merger agreement with Safran that allegedly discourage competing offers from other potential bidders and/or benefit defendants. The Shareholder Actions generally allege that the Company aided and abetted these alleged breaches of fiduciary duty. Certain of the suits also allege claims against Safran, Merger Sub, BAE and BAE Systems,



Inc. (the parent entity to BAE and the U.S. affiliate of BAE Systems plc) for aiding and abetting the foregoing alleged breaches of fiduciary duty. The Shareholder Actions generally seek preliminary and permanent relief, including, among other things, permission to proceed as a class action, declaratory relief declaring that defendants have breached their fiduciary duties, an injunction enjoining the transactions contemplated by the Merger Agreement and BAE Purchase Agreement, recessionary damages in the event that the Transactions are consummated, costs and attorneys and experts fees.

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The Company believes the lawsuits are without merit and intends to vigorously defend against them. As of the date of this Form 10-Q, the Company's time to respond to the complaints has not yet expired.

### *Old Digimarc Litigation*

In connection with the Company's August 2008 acquisition of Old Digimarc, which consisted of its Secure ID Business following the spin-off of its digital watermarking business, the Company assumed certain legal proceedings of Old Digimarc as described below.

Beginning in May 2001, a number of substantially identical class action complaints alleging violations of the federal securities laws were filed in the United States District Court for the Southern District of New York naming approximately 300 companies, including Old Digimarc, certain officers and directors and certain underwriters of the companies' initial public offerings as defendants. The complaints were subsequently consolidated into a single action, and a consolidated amended complaint was filed in April 2002. The amended complaint alleges, among other things, that the underwriters of Old Digimarc's initial public offering violated securities laws by failing to disclose certain alleged compensation arrangements in Old Digimarc's initial public offering registration statement and by engaging in manipulative practices to artificially inflate the price of Old Digimarc's stock in the aftermarket subsequent to the initial public offering. Old Digimarc and certain of its officers and directors are named in the amended complaint pursuant to Section 11 of the Securities Act of 1933 and Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 on the basis of an alleged failure to disclose the underwriters' alleged compensation arrangements and manipulative practices. The complaint sought unspecified damages. In July 2002, the claims against Old Digimarc under Section 10(b) were dismissed. In October 2002, the individual officer and director defendants were dismissed without prejudice pursuant to tolling agreements. Subsequent addenda to these tolling agreements extended the tolling period through August 27, 2010. In June 2004, a stipulation of partial settlement among the plaintiffs, the companies, and the officers and directors was submitted to the District Court. While the partial settlement was pending approval, the plaintiffs continued to litigate their claims against the underwriter defendants. The district court directed that the litigation proceed within a number of focus cases rather than in all of the 309 cases that have now been consolidated. Old Digimarc was not one of these focus cases. In October 2004, the district court certified the focus cases as class actions. The underwriter defendants appealed that ruling and, on December 5, 2006, the Court of Appeals for the Second Circuit reversed the district court's class certification decision for the six focus cases. In light of the Second Circuit opinion, in June 2007, the district court entered an order terminating the settlement. On August 14, 2007, the plaintiffs filed their second consolidated amended class action complaints against the focus cases and on September 27, 2007, again moved for class certification. On November 12, 2007, certain of the defendants in the focus cases moved to dismiss the second consolidated amended class action complaints. The court issued an opinion and order on March 26, 2008, denying the motions to dismiss except as to Section 11 claims raised by those plaintiffs who sold their securities for a price in excess of the initial offering price and those who purchased outside the previously certified class period. The class certification motion was withdrawn without prejudice on October 10, 2008. On April 2, 2009, a stipulation and agreement of settlement among the plaintiffs, issuer defendants (including Old Digimarc) and underwriter defendants was submitted to the Court for preliminary approval. Old Digimarc's portion of the settlement, which is wholly immaterial, is covered entirely by insurance.

On June 10, 2009, the Judge granted preliminary approval of the settlement, and on October 5, 2009, the Judge granted final approval of the settlement. On August 26, 2010, based on the expiration of the tolling period stated in the tolling agreements with the individual officers and directors, the plaintiffs filed a Notice of Termination of Tolling Agreement and Recommencement of Litigation against the named officers and directors. The plaintiffs stated to the Court that they do not intend to take any further action against the named officers and directors at this time. Notices of appeal of the opinion granting final approval were filed by six groups of appellants. In October 2010, four of the groups of appellants withdrew their appeals with prejudice. Briefing on the remaining two appeals is ongoing.

On October 10, 2007, an Old Digimarc shareholder filed a lawsuit in the United States District Court for the Western District of Washington against several companies that acted as lead underwriters for the Old Digimarc initial public offering. The complaint, which also named Old Digimarc as a nominal defendant but did not assert any claims against Old Digimarc, asserted claims against the underwriters under Section 16(b) of the Securities Exchange Act of 1934. On February 28, 2008, an amended complaint was filed, with Old Digimarc still named only as a nominal

defendant.

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Similar complaints have been filed by this same plaintiff against a number of other issuers in connection with their initial public offerings, and the factual allegations are closely related to the allegations in the litigation pending in the United States District Court for the Southern District of New York which is described above. On March 12, 2009, after considering motions to dismiss, one filed by thirty moving issuers and the other filed by the underwriters, the judge dismissed the plaintiff's claims on a jurisdictional and statute of limitations basis. On April 10, 2009, the plaintiff filed a notice of appeal of the dismissal. The final appellate brief was filed on November 17, 2009; and oral argument was heard by the Ninth Circuit Court of Appeals on October 5, 2010. The Company currently believes that the outcome of this litigation will not have a material adverse impact on its condensed consolidated financial position and results of operations.

### *Patent Litigation*

On May 12, 2010, the Company was served with a complaint in the U.S. District Court, District of Delaware, alleging patent infringement of US Patent No. 5,913,542 regarding the making, using, offering for sale and selling of ID cards, including drivers' licenses. On August 19, 2010, the Company filed an amended answer to the complaint, which contained counterclaims for declaratory judgment against the plaintiff. Based on the preliminary nature of the proceedings, it is not possible at this stage to quantify the potential damages, exposure or liability to L-1, if any.

### *Other*

The Company records a liability for any claim, demand, litigation and other contingency when management believes that it is both probable that a liability has been incurred and can reasonably estimate the amount of the potential loss. Based on current information and belief, the Company believes it has adequate provisions for any such matters. The Company reviews these provisions quarterly and adjusts these provisions to reflect the impact of negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to a particular matter. However, because of the inherent uncertainties of litigation the ultimate outcome of certain litigation cannot be accurately predicted by the Company; it is therefore possible that the consolidated financial position, results of operations or cash flows of the Company could be materially adversely affected in any particular period by the unfavorable resolution of one or more of these matters and contingencies.

## **10. INCOME TAXES**

For the nine months ended September 30, 2010 and 2009 the tax benefit from continuing operations was \$4.1 million and a provision of \$0.2 million, respectively and the pre-tax loss was \$19.0 million and \$0.8 million, respectively. The tax benefit from discontinued operations for the nine months ended September 30, 2010 and 2009 was \$2.2 million and \$1.6 million, respectively. The tax benefit was allocated between continued and discontinued operations by first calculating the provision on a consolidated basis including discontinuing operations and then calculating the provision excluding the discontinued operations. The difference between the two calculations was then allocated to discontinued operations.

The tax benefit is based on an estimated annual effective tax rate applied to the cumulative year to date results for both periods. Separate annual effective tax rates were used for entities that file returns on a separate company basis and expect to report losses for the full year, which have an estimated annual effective tax rate of 0%. The remaining entities included in the condensed consolidated financial statements have estimated annual effective tax rates of 34% and 39% for the nine months ended September 30, 2010 and 2009. The provision for the nine months ended September 30, 2010 also reflects the impact of the discrete items, (including certain transactions costs associated with the sale of the Company), which are not deductible for federal income tax purposes.

In connection with the sale of the Intel Business, the Company expects to recognize a significant gain for financial and tax reporting purposes, which is estimated to result in a current tax liability of approximately \$20.0 million. The tax effects of the sale will be reflected as discrete items in the period during which the sale is consummated.

## **11. SEGMENT REPORTING, GEOGRAPHICAL INFORMATION AND CONCENTRATIONS OF RISK**

The Company's operating segments have been aggregated in two reportable segments: Solutions and Services. The Solutions reportable segment provides solutions that enable governments, law enforcement agencies, and businesses to enhance security, reduce identity theft, and protect personal privacy utilizing secure credential provisioning and authentication systems, biometric technology and the creation, enhancement and/or utilization of identity databases.



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The Services reportable segment provides finger-print based background checks enrollment services to government, civil, and commercial customers. The following segment information has been retroactively adjusted to reflect the SpecTal/McClendon and Advanced Concepts operating segments as discontinued operations effective September 19, 2010. The Company measures segment performance primarily based on revenues and operating income (loss) and Adjusted EBITDA. Operating results by segment, including allocation of corporate expenses, for the three and nine months ended September 30, 2010 and 2009 are as follows (in thousands):

|   | <b>Three Months Ended</b> |                  | <b>Nine Months Ended</b> |                  |
|---|---------------------------|------------------|--------------------------|------------------|
|   | <b>September</b>          | <b>September</b> | <b>September</b>         | <b>September</b> |
|   | <b>30,</b>                | <b>30,</b>       | <b>30,</b>               | <b>30,</b>       |
|   | <b>2010</b>               | <b>2009</b>      | <b>2010</b>              | <b>2009</b>      |
| <b>Solutions:</b>                                       |                           |                  |                          |                  |
| Revenues  | \$ 89,573                 | \$ 88,476        | \$ 234,665               | \$ 245,610       |
| Operating Income (Loss)                                 | (2,238)                   | 7,768            | (3,015)                  | 8,607            |
| Depreciation and Amortization Expense                   | 9,142                     | 7,274            | 25,310                   | 22,043           |
| <b>Services:</b>  |                           |                  |                          |                  |
| Revenues  | 31,439                    | 30,757           | 88,944                   | 84,526           |
| Operating Income (Loss)                                 | (1,625)                   | 537              | (3,034)                  | 1,522            |
| Depreciation and Amortization Expense                   | 971                       | 708              | 2,856                    | 1,904            |
| <b>Consolidated:</b>                                    |                           |                  |                          |                  |
| Revenues  | \$ 121,012                | \$ 119,233       | \$ 323,609               | \$ 330,136       |
| Operating Income (Loss)                                 | (3,863)                   | 8,305            | (6,049)                  | 10,129           |
| Depreciation and Amortization Expense                   | 10,113                    | 7,982            | 28,166                   | 23,947           |
| Total assets and goodwill by segment as (in thousands): |                           |                  |                          |                  |

|           | <b>As of September 30, 2010</b> |                   |
|-----------|---------------------------------|-------------------|
|           | <b>Total</b>                    | <b>Goodwill</b>   |
| Solutions | \$ 920,037                      | \$ 625,912        |
| Services  | 100,139                         | 74,856            |
| Corporate | 341,391                         |                   |
|           | <b>\$ 1,361,567</b>             | <b>\$ 700,768</b> |

Corporate assets consist primarily of assets held for sale, cash and cash equivalents, deferred financing costs and net deferred tax assets.

Revenues by market are as follows for the three and nine months ended September 30, 2010 and 2009 (in thousands):

|                             | <b>Three Months Ended</b> |                   | <b>Nine Months Ended</b> |                   |
|-----------------------------|---------------------------|-------------------|--------------------------|-------------------|
|                             | <b>September</b>          | <b>September</b>  | <b>September</b>         | <b>September</b>  |
|                             | <b>30,</b>                | <b>30,</b>        | <b>30,</b>               | <b>30,</b>        |
|                             | <b>2010</b>               | <b>2009</b>       | <b>2010</b>              | <b>2009</b>       |
| Federal                     | \$ 40,181                 | \$ 56,489         | \$ 109,429               | \$ 138,409        |
| State and Local             | 74,024                    | 58,119            | 195,821                  | 176,721           |
| Commercial/Emerging Markets | 6,807                     | 4,625             | 18,359                   | 15,006            |
|                             | <b>\$ 121,012</b>         | <b>\$ 119,233</b> | <b>\$ 323,609</b>        | <b>\$ 330,136</b> |

The Company's operations outside the United States include wholly-owned subsidiaries in Bochum, Germany, Oakville, Canada, Mexico City, Mexico, and Markham, Canada. Revenues are attributed to each region based on the

location of the customer. The following is a summary of revenues by geographic areas (in thousands):

|                   | <b>Three Months Ended</b> |                  | <b>Nine Months Ended</b> |                  |
|-------------------|---------------------------|------------------|--------------------------|------------------|
|                   | <b>September</b>          | <b>September</b> | <b>September</b>         | <b>September</b> |
|                   | <b>30,</b>                | <b>30,</b>       | <b>30,</b>               | <b>30,</b>       |
|                   | <b>2010</b>               | <b>2009</b>      | <b>2010</b>              | <b>2009</b>      |
| United States     | \$ 108,129                | \$ 103,239       | \$ 282,988               | \$ 285,831       |
| Rest of the World | 12,883                    | 15,994           | 40,621                   | 44,305           |
|                   | \$ 121,012                | \$ 119,233       | \$ 323,609               | \$ 330,136       |

For the three and nine months ended September 30, 2010, U.S. Federal Government agencies, directly or indirectly, accounted for 33 percent and 34 percent of consolidated revenues, respectively. For the three and nine months ended September 30, 2009, U.S. Federal Government agencies, directly or indirectly accounted for 47 percent and 42 percent of consolidated revenues, respectively.

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**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**Overview**

The following discussion and analysis should be read in conjunction with the consolidated financial statements and the accompanying notes contained in L-1's 2009 Annual Report on Form 10-K and the condensed consolidated financial statements and the accompanying notes contained in this Quarterly Report on Form 10-Q.

L-1 Identity Solutions, Inc. ( "L-1" or the "Company" ) is a provider of technology, products, systems and solutions, and services that protect and secure personal identities and assets. Together with its divisions, L-1 delivers the full range of offerings required for solving complex problems associated with managing identity. The Company operates in two reportable segments: Solutions and Services.

The Solutions reportable segment consists of the Secure Credentialing and Biometrics / Enterprise Access operating segments. Solutions from these operating segments are marketed to Federal agencies, State and Local government agencies (including law enforcement and department of corrections), foreign governments, and commercial entities (such as financial and health care institutions and casinos). Solutions revenue includes products and related services, which are comprised of hardware, components, consumables and software, as well as maintenance; consulting and training services, which are generally sold in bundled solutions.

Prior to September 30, 2010, the Services segment includes Enrollment Services, SpecTal/McClendon and Advanced Concepts. Enrollment Services performs fingerprint-based background checks necessary for federal and state licensed employment in the banking, finance, insurance, healthcare, legal, real estate, education and other industries. SpecTal/McClendon and Advanced Concepts provide services to the national security and intelligence community in the U.S. today, including information technology, engineering and analytics, and intelligence. Subsequent to September 30, 2010, the Services segment consists of the Enrollment Services operating segment. SpecTal/McClendon and Advanced Concepts are now accounted as discontinued operations.

The Company evaluates businesses and their management primarily through financial metrics including revenues, operating income (loss) and Adjusted EBITDA (earnings before interest expense-net, depreciation and amortization, stock-based compensation expense, asset impairments and provision (benefit) for income taxes).

**Pending Transactions**

In January 2010, L-1 announced that one of its strategic goals and objectives for 2010 was to explore strategic alternatives to enhance shareholder value. Subsequently, on September 19, 2010, the Company entered into an agreement (the "Merger Agreement") with Safran SA ( "Safran" ) and Laser Acquisition Sub Inc. ( "Merger Sub" ), a wholly owned subsidiary of Safran, pursuant to which, subject to the terms and conditions of the Merger Agreement, the Company is to be acquired by Safran in a merger transaction providing for shareholders to receive \$12.00 per share in cash, for an aggregate enterprise value of approximately \$1.6 billion, inclusive of outstanding debt. See Note 3 to our consolidated financial statements for additional information. Completion of the merger remains subject to certain conditions, including, among others (i) the disposition of our SpecTal/McClendon and Advanced Concepts businesses as described below; (ii) approval of the merger transaction by our shareholders; (iii) the expiration or termination of the applicable waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (the "HSR Act"); (iv) termination or expiration of the Committee on Foreign Investment in the United States ( "CFIUS" ) review period pursuant to the Exon-Florio Provision of the Defense Production Act of 1950; (v) completion of the novation, termination or expiration of certain contracts; (vi) no Company Material Adverse Effect (as defined in the Merger Agreement) having occurred since the date of the Merger Agreement; (vii) subject to certain materiality exceptions, the accuracy of the representations and warranties made by the Company and Safran and compliance by the Company and Safran with their respective obligations under the Merger Agreement; (viii) no law or government order prohibiting the merger; and (ix) other customary conditions.

Also on September 19, 2010, the Company entered in a definitive agreement (the "BAE Purchase Agreement") to sell SpecTal/McClendon and Advanced Concepts (the "Intel Business") to BAE Systems Information Solutions, Inc. ( "BAE" ) (a subsidiary of BAE Systems, Inc., the U.S. affiliate of BAE Systems plc) for a purchase price of \$295.8 million in cash (and approximately \$7.2 million in assumed obligations), the net proceeds of which (as defined in the credit agreement) will be used to repay outstanding debt under the Company's credit agreement.





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Completion of the sale remains subject to certain conditions, including, among others, (i) the expiration or termination of the applicable waiting periods under the HSR Act; (ii) termination or expiration of the CFIUS review period; (iii) no Business Material Adverse Effect (as defined in the BAE Purchase Agreement) having occurred since the date of the BAE Purchase Agreement; (iv) subject to certain materiality exceptions, the accuracy of the representations and warranties made by the Company and BAE and compliance by the Company and BAE with their respective obligations under the BAE Purchase Agreement; (v) the completion of certain actions in respect of organizational conflict of interest provisions under certain contracts of the business; (vi) no law or judgment prohibiting the sale and (vii) other customary conditions. The purchase price is subject to adjustment based on the working capital of the Intel Business at closing.

## **Business Trends**

In the last two years management considered the following factors, among others in evaluating its financial condition and operating results:

Our Biometrics operating segment, while having significant growth opportunities, may be subject to the lengthy sales cycles involved in large government procurements domestically and internationally. For example, during 2009 and 2010 the Company experienced a delay regarding the sale of an increased capacity license relating to a sole source program. A portion of the capacity license was delivered in the second quarter of 2010 with the remainder being delivered in the third quarter of 2010. In recent months, the division has expanded its marketing and proposal efforts outside the United States.

Our Secure Credentialing operating segment has been successful in winning large competitive credentialing contracts and continues to have significant opportunities in assisting US DMVs with cost effective and efficient programs. International new awards can be subject to lengthy sales cycles and delays, as recently has been the case in connection with certain programs in Africa and South America.

We have been awarded 20 out of 24 competitive driver license contracts and contract extensions since January 1, 2009, which will result in significant revenue increases over the term of the contracts once the systems are implemented. These secure solutions require up front capital expenditures before such revenue increases are realized. Capital expenditures, which are primarily related to the secure credentialing business, aggregated approximately \$55.0 million in 2009 and are expected to be in the range of \$40.0 million to \$45.0 million in 2010. We expect that there will be a decline in capital expenditures in 2011 as the majority of our recently awarded driver's license contracts will be implemented.

Our Intel Business which is included in discontinued operations has grown its revenues despite the publicly announced goal of certain agencies in the intelligence community to reduce reliance on outside contractors.

Our existing credit agreement which was executed in August 2008 in the midst of the severe global economic crisis contains certain restrictions, principal repayment schedules and financial covenants that are significantly more restrictive than those prevailing in the current lending environment. In 2009 and 2010, we amended the credit agreement to reduce the principal payments on a permanent basis, and recently modified certain financial covenants to provide for significant operating flexibility as we continue to operate the businesses pending completion of the sale transactions with Safran and BAE. We will be required to use the proceeds from the sale of our Intel Business to pay down outstanding debt under the credit agreement.

While we have grown significantly through acquisitions, we have not consummated any acquisitions since the August 2008 acquisition of the secure ID systems business of Digimarc, as we have focused on growing the existing business to improve our liquidity and completing our strategic alternative process.

The results of operations of the Company have been impacted by the considerations described above. Additional specific events that directly impacted the financial condition, results of operations and cash flows are discussed in the Consolidated Results of Operations and Liquidity and Capital Resources sections.



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Revenues from continuing operations, increased to \$121.0 million and decreased to \$323.6 million for the three and nine months ended September 30, 2010, from \$119.2 million and \$330.1 million for the three and nine months ended September 30, 2009, respectively. L-1's net loss from continuing operations for the three and nine months ended September 30, 2010 was \$6.6 million and \$15.0 million, compared to a net income from continuing operations of \$3.0 million and a net loss of \$1.0 million for the three and nine months ended September 30, 2009. The net loss from continuing operations in 2010 includes a pre-tax impairment charge of \$2.9 million related to Registered Traveler program and pre-tax charges of \$6.1 million and \$7.9 million for the three and nine months ended September 30, 2010, respectively, of direct costs related to the strategic alternative process that resulted in executing definitive agreements to sell the Company. In addition \$3.3 million of strategic alternative costs are included in discontinued operations.

The net loss from discontinued operations for the three and nine months ended September 30, 2010 was \$2.6 million and \$4.5 million, respectively, compared to a corresponding net loss of \$1.7 million and \$2.7 million for the three and nine months ended September 30, 2009, respectively. In the fourth quarter of 2010, the Company expects to recognize a pre-tax gain on the sale between \$40.0 million and \$50.0 million, depending on the net carrying amount of the discontinued business at the closing of the sale of the Intel Business.

**Consolidated Adjusted EBITDA**

L-1 uses Adjusted EBITDA as a non-GAAP financial performance measurement. Adjusted EBITDA is calculated by adding back to net income (loss): interest-net, income taxes, depreciation and amortization, goodwill and long-lived asset impairments and stock-based compensation, including retirement plan contributions settled, or to be settled, in common stock. Adjusted EBITDA is provided to investors to supplement the results of operations reported in accordance with GAAP. Management believes Adjusted EBITDA is useful to help investors analyze the operating trends of the business and to assess the relative underlying performance of businesses with different capital and tax structures. Management also believes that Adjusted EBITDA provides an additional tool for investors to use in comparing L-1's financial results with other companies in the industry, many of which also use Adjusted EBITDA in their communications to investors. By excluding non-cash charges such as amortization and depreciation, stock-based compensation expense, goodwill and long-lived asset impairments as well as non-operating charges for interest-net and income taxes, investors can evaluate L-1's operations and can compare L-1's results on a more consistent basis to the results of other companies. Management uses Adjusted EBITDA to evaluate potential acquisitions, establish internal budgets and goals, evaluate performance of L-1's business units and management, and to assess compliance with financial debt covenants.

L-1 considers Adjusted EBITDA to be an important indicator of the Company's operational strength and performance of its business and a useful measure of L-1's historical and prospective operating trends. However, there are significant limitations to the use of Adjusted EBITDA since it excludes interest income and expense, income taxes, goodwill and long-lived asset impairments, and stock-based compensation expense, including retirement plan contributions settled, or to be settled in common stock, all of which impact L-1's profitability, as well as depreciation, and amortization related to the use of long-lived assets that benefit multiple periods. The Company believes that these limitations are compensated for by providing Adjusted EBITDA only with GAAP performance measures and clearly identifying the difference between the two measures. Consequently, Adjusted EBITDA should not be considered in isolation or as a substitute for net income (loss), or operating income (loss) presented in accordance with GAAP. Adjusted EBITDA as defined by the Company may not be comparable with similarly named measures provided by other entities.

A reconciliation of GAAP net income (loss) to Adjusted EBITDA (including both continuing and discontinued operations) follows (in thousands):

|                                      | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|--------------------------------------|---|-------------|--|-------------|
|                                      | <b>2010</b>                                 | <b>2009</b> | <b>2010</b>                                | <b>2009</b> |
| Net Income (Loss)                    | \$ (9,175)                                  | \$ 1,372    | \$ (19,412)                                | \$ (3,658)  |
| Provision (Benefit) for Income Taxes | (3,571)                                     | 817         | (6,318)                                    | (1,428)     |

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|                                |           |           |           |           |
|--------------------------------|-----------|-----------|-----------|-----------|
| Interest, net                  | 10,547    | 11,668    | 30,529    | 31,602    |
| Stock-Based Compensation Costs | 5,814     | 5,328     | 18,008    | 16,225    |
| Asset Impairment Charge        | 2,915     |           | 2,915     |           |
| Depreciation and Amortization  | 10,997    | 9,127     | 31,350    | 27,411    |
| Consolidated Adjusted EBITDA   | \$ 17,527 | \$ 28,312 | \$ 57,072 | \$ 70,152 |

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**Table of Contents****REPORTABLE SEGMENTS AND GEOGRAPHIC INFORMATION**

L-1 operates in two reportable segments, the Solutions segment and the Services segment. The following information has been retroactively adjusted to report the SpecTal/McClendon and Advance Concepts operating segments as discontinued operations. L-1 measures segment performance primarily based on revenues, operating income (loss) and Adjusted EBITDA. Operating results by segment, including allocation of corporate expenses, for the three and nine months ended September 30, 2010 and 2009, are as follows (in thousands):

|                                       | <b>Three Months Ended</b> |                  | <b>Nine Months Ended</b> |                  |
|---------------------------------------|---------------------------|------------------|--------------------------|------------------|
|                                       | <b>September</b>          | <b>September</b> | <b>September</b>         | <b>September</b> |
|                                       | <b>30,</b>                | <b>30,</b>       | <b>30,</b>               | <b>30,</b>       |
|                                       | <b>2010</b>               | <b>2009</b>      | <b>2010</b>              | <b>2009</b>      |
| <b>Solutions:</b>                     |                           |                  |                          |                  |
| Revenues                              | \$ 89,573                 | \$ 88,476        | \$ 234,665               | \$ 245,610       |
| Operating Income (Loss)               | (2,238)                   | 7,768            | (3,015)                  | 8,607            |
| Depreciation and Amortization Expense | 9,142                     | 7,274            | 25,310                   | 22,043           |
| Adjusted EBITDA                       | 11,062                    | 15,701           | 31,587                   | 38,077           |
| <b>Services:</b>                      |                           |                  |                          |                  |
| Revenues                              | 31,439                    | 30,757           | 88,944                   | 84,526           |
| Operating Income (Loss)               | (1,625)                   | 537              | (3,034)                  | 1,522            |
| Depreciation and Amortization Expense | 971                       | 708              | 2,856                    | 1,904            |
| Adjusted EBITDA                       | (879)                     | 1,196            | (200)                    | 4,065            |
| <b>Consolidated:</b>                  |                           |                  |                          |                  |
| Revenues                              | 121,012                   | 119,233          | 323,609                  | 330,136          |
| Operating Income (Loss)               | (3,863)                   | 8,305            | (6,049)                  | 10,129           |
| Depreciation and Amortization Expense | 10,113                    | 7,982            | 28,166                   | 23,947           |
| Adjusted EBITDA                       | \$ 10,183                 | \$ 16,897        | \$ 31,387                | \$ 42,142        |

Revenues by market for the three and nine months ended September 30, 2010 and 2009 are as follows (in thousands):

|                             | <b>Three Months Ended</b> |                  | <b>Nine Months Ended</b> |                  |
|-----------------------------|---------------------------|------------------|--------------------------|------------------|
|                             | <b>September</b>          | <b>September</b> | <b>September</b>         | <b>September</b> |
|                             | <b>30,</b>                | <b>30,</b>       | <b>30,</b>               | <b>30,</b>       |
|                             | <b>2010</b>               | <b>2009</b>      | <b>2010</b>              | <b>2009</b>      |
| Federal                     | \$ 40,181                 | \$ 56,489        | \$ 109,429               | \$ 138,409       |
| State and Local             | 74,024                    | 58,119           | 195,821                  | 176,721          |
| Commercial/Emerging Markets | 6,807                     | 4,625            | 18,359                   | 15,006           |
|                             | \$ 121,012                | \$ 119,233       | \$ 323,609               | \$ 330,136       |

Revenues are attributed to each region based on the location of the customer. The following is a summary of revenues by geographic region (in thousands):

|                   | <b>Three Months Ended</b> |                  | <b>Nine Months Ended</b> |                  |
|-------------------|---------------------------|------------------|--------------------------|------------------|
|                   | <b>September</b>          | <b>September</b> | <b>September</b>         | <b>September</b> |
|                   | <b>30,</b>                | <b>30,</b>       | <b>30,</b>               | <b>30,</b>       |
|                   | <b>2010</b>               | <b>2009</b>      | <b>2010</b>              | <b>2009</b>      |
| United States     | \$ 108,129                | \$ 103,239       | \$ 282,988               | \$ 285,831       |
| Rest of the World | 12,883                    | 15,994           | 40,621                   | 44,305           |
|                   | \$ 121,012                | \$ 119,233       | \$ 323,609               | \$ 330,136       |

For the three and nine months ended September 30, 2010, U.S. Federal Government agencies, directly or indirectly, accounted for 33 percent and 34 percent of consolidated revenues, respectively. For the three and nine month periods ended September 30, 2009, U.S. Federal Government agencies, directly or indirectly accounted for 47 percent and 42 percent of consolidated revenues, respectively. Accounts receivable from U.S. government agencies amounted to \$11.2 million and \$17.2 million at September 30, 2010 and 2009, respectively.

**DISCONTINUED OPERATIONS**

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Effective with the quarter ended September 30, 2010, the Intel Business has been presented as discontinued operations. The following table summarizes operating data related to discontinued operations (in thousands):

|  | <b>Three Months Ended</b>         |                                   | <b>Nine Months Ended</b>          |                                   |
|--|-----------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|
|  | <b>September<br/>30,<br/>2010</b> | <b>September<br/>30,<br/>2009</b> | <b>September<br/>30,<br/>2010</b> | <b>September<br/>30,<br/>2009</b> |
| Revenues                                 | \$ 54,877                         | \$ 53,305                         | \$ 164,610                        | \$ 160,644                        |
| Cost of sales                            | 38,956                            | 37,803                            | 117,148                           | 113,795                           |
| Operating expenses                       | 10,727                            | 9,780                             | 32,923                            | 30,190                            |
| Operating income                         | 5,194                             | 5,722                             | 14,539                            | 16,659                            |
| Interest expense                         | 6,169                             | 8,013                             | 17,956                            | 20,851                            |
| Strategic alternative transactions costs | 3,328                             |                                   | 3,328                             |                                   |
| Other income (expense)                   | 26                                | (65)                              | 51                                | (111)                             |
| Loss before income taxes                 | (4,277)                           | (2,356)                           | (6,694)                           | (4,303)                           |
| Benefit for income taxes                 | 1,672                             | 689                               | 2,240                             | 1,596                             |
| Net loss from discontinued operations    | \$ (2,605)                        | \$ (1,667)                        | \$ (4,454)                        | \$ (2,707)                        |

Revenues from discontinued operations increased by \$1.6 million and \$4.0 million in the three and nine months ended September 30, 2010, respectively, as compared to the corresponding period in the previous year and reflects the impact of competitive pressures and the goal of certain agencies in the intelligence community to reduce reliance on subcontractors. Operating margins were 9.5 percent and 10.7 percent for the three months ended September 30, 2010 and 2009, respectively, and 8.8 percent and 10.4 percent for the nine months ended September 30, 2010 and 2009 and reflect increased bid and proposal costs in 2010.

Interest expense represents costs incurred in connection with the debt required to be repaid from the proceeds from the sale of the discontinued operations. Strategic alternative transaction costs represent costs incurred to date in connection with the sale of the Intel Business.

**CONTINUING OPERATIONS****Revenues (in thousands)**

|          | <b>Three Months Ended</b>         |                                   | <b>Nine Months Ended</b>          |                                   |
|----------|-----------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|
|          | <b>September<br/>30,<br/>2010</b> | <b>September<br/>30,<br/>2009</b> | <b>September<br/>30,<br/>2010</b> | <b>September<br/>30,<br/>2009</b> |
| Revenues | \$ 121,012                        | \$ 119,233                        | \$ 323,609                        | \$ 330,136                        |

Revenues increased to approximately \$121.0 million for the three months ended September 30, 2010 compared to approximately \$119.2 million for the three months ended September 30, 2009, representing an increase of \$1.8 million. Revenues decreased to approximately \$323.6 million for the nine months ended September 30, 2010 compared to approximately \$330.1 million for the nine months ended September 30, 2009, representing a decrease of \$6.5 million. Revenues increased due to higher sales of capacity licenses of approximately \$5.9 million and \$6.7 million for the three and nine months ended September 30, 2010, respectively, as well as higher volumes in our enrollment services businesses and revenue growth in our state drivers licenses contracts. These increases were offset by lower HIIDE and Passcard shipments for both the three and nine month periods, compared to the corresponding periods in the prior year.

**Products and Services Revenues:**



The following represents details the revenues attributable to products and services for the three and nine months ended September 30, 2010 and 2009 (in thousands):

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|                                      | <b>Three Months Ended</b> |                  | <b>Nine Months Ended</b> |                  |
|--------------------------------------|---------------------------|------------------|--------------------------|------------------|
|                                      | <b>September</b>          | <b>September</b> | <b>September</b>         | <b>September</b> |
|                                      | <b>30,</b>                | <b>30,</b>       | <b>30,</b>               | <b>30,</b>       |
|                                      | <b>2010</b>               | <b>2009</b>      | <b>2010</b>              | <b>2009</b>      |
| Services:                            |                           |                  |                          |                  |
| U.S. Federal government services     | \$ 6,539                  | \$ 8,103         | \$ 19,938                | \$ 27,441        |
| State and local government services  | 24,900                    | 22,654           | 69,006                   | 57,085           |
| Total Services                       | 31,439                    | 30,757           | 88,944                   | 84,526           |
| Solutions:                           |                           |                  |                          |                  |
| State and local government solutions | 33,497                    | 30,622           | 91,585                   | 88,992           |
| Hardware and consumables             | 18,297                    | 31,492           | 58,661                   | 86,411           |
| Software, licensing fees and other   | 29,198                    | 17,618           | 58,282                   | 45,671           |
| Maintenance                          | 8,581                     | 8,744            | 26,137                   | 24,536           |
| Total Solutions                      | 89,573                    | 88,476           | 234,665                  | 245,610          |
| Total Revenues                       | \$ 121,012                | \$ 119,233       | \$ 323,609               | \$ 330,136       |

Services revenues included in continuing operations represent revenues from enrollment services contracts for which the Company is compensated based on volume of enrollments performed. Solutions revenues comprise revenues from the delivery of consumables and equipment, as well as hardware, software and systems that include related services, primarily maintenance bundled with the related product deliverables. Because the product functionality is the primary deliverable for the customer, we have included the total revenues from these arrangements in solutions revenues. Solutions revenues also include revenues related to driver's license production contracts for which we provide systems and maintenance, produce the licenses and are compensated in one all inclusive price per license as the licenses are produced.

**Cost of Revenues and Gross Margin (in thousands)**

|   | <b>Three Months Ended</b> |                  | <b>Nine Months Ended</b> |                  |
|---|---------------------------|------------------|--------------------------|------------------|
|   | <b>September</b>          | <b>September</b> | <b>September</b>         | <b>September</b> |
|   | <b>30,</b>                | <b>30,</b>       | <b>30,</b>               | <b>30,</b>       |
|   | <b>2010</b>               | <b>2009</b>      | <b>2010</b>              | <b>2009</b>      |
| Cost of revenues, excluding items noted below | \$ 74,468                 | \$ 72,614        | \$ 206,357               | \$ 207,993       |
| Depreciation and amortization expense         | 7,525                     | 5,652            | 20,590                   | 16,847           |
| Amortization of acquired intangible assets    | 1,334                     | 1,260            | 3,894                    | 4,094            |
| Stock-based compensation                      | 306                       | 214              | 796                      | 686              |
| Total cost of revenues                        | \$ 83,633                 | \$ 79,740        | \$ 231,637               | \$ 229,620       |
| Gross profit                                  | \$ 37,379                 | \$ 39,493        | \$ 91,972                | \$ 100,516       |
| Gross margin                                  | 31%                       | 33%              | 28%                      | 30%              |

Cost of revenues increased by \$3.9 million and \$2.0 million for the three and nine months ended September 30, 2010, respectively, compared to the prior year. The increase in the three and nine month periods reflects the impact of

increased volumes of enrollment services and drivers license revenues, offset by lower Passcard and HIIDE shipments. Margins were 31 percent and 28 percent for the three and nine month period ended September 30, 2010, respectively, compared to 33 percent and 30 percent in the corresponding periods in the prior year and are primarily related to the sales mix as noted above. Included in the cost of revenues for the three and nine months ended September 30, 2010, were non cash charges of \$9.2 million and \$25.3 million, respectively, compared to corresponding amounts of \$7.1 million and \$21.6 million in the same period in 2009.

**Sales and Marketing Expenses (in thousands)**

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|                              | <b>Three Months Ended</b> |                  | <b>Nine Months Ended</b> |                  |
|------------------------------|---------------------------|------------------|--------------------------|------------------|
|                              | <b>September</b>          | <b>September</b> | <b>September</b>         | <b>September</b> |
|                              | <b>30,</b>                | <b>30,</b>       | <b>30,</b>               | <b>30,</b>       |
|                              | <b>2010</b>               | <b>2009</b>      | <b>2010</b>              | <b>2009</b>      |
| Sales and marketing expenses | \$ 9,344                  | \$ 10,476        | \$ 27,698                | \$ 29,839        |
| As a percentage of revenues  | 8%                        | 9%               | 9%                       | 9%               |

Sales and marketing expenses decreased by approximately \$1.1 million and \$2.1 million for the three and nine months ended September 30, 2010, respectively, compared to the prior year period. The decrease for both the three and nine month periods is primarily attributable to lower payroll related expenses as a result of lower headcount. Sales and marketing expenses consists primarily of salaries and costs including stock-based compensation, commissions, travel and entertainment expenses, promotions and other marketing and sales support expenses.

**Research and Development Expenses (in thousands)**

|                                   | <b>Three Months Ended</b> |                  | <b>Nine Months Ended</b> |                  |
|-----------------------------------|---------------------------|------------------|--------------------------|------------------|
|                                   | <b>September</b>          | <b>September</b> | <b>September</b>         | <b>September</b> |
|                                   | <b>30,</b>                | <b>30,</b>       | <b>30,</b>               | <b>30,</b>       |
|                                   | <b>2010</b>               | <b>2009</b>      | <b>2010</b>              | <b>2009</b>      |
| Research and development expenses | \$ 6,262                  | \$ 6,114         | \$ 16,787                | \$ 17,679        |
| As a percentage of revenues       | 5%                        | 5%               | 5%                       | 5%               |

Research and development expenses increased by approximately \$0.1 million and decreased by \$0.9 million for the three and nine months ended September 30, 2010 compared to the corresponding periods in 2009. L-1 continues to focus on enhancing our credentialing and biometric solutions offerings while at the same time maximizing our research costs to focus on those activities with the greatest technological and revenue potential. Gross research and development expenses were offset by higher utilization of research and development resources in the performance of contracts, the cost of which is included in cost of revenues, and in other projects. Gross research and development expenditures aggregated \$12.8 million and \$38.0 million for the three and nine months ended September 30, 2010, respectively, compared to \$12.5 million and \$35.1 million for the comparable period in the prior year. Virtually all of our research and development costs are attributable to our Solutions segment. As a percentage of Solutions revenues, gross research and development costs were 16 percent and 14 percent for the nine months ended September 30, 2010 and 2009, respectively. Research and development expenses consist primarily of salaries and related personnel costs, including stock-based compensation and other costs related to the design, development, testing and enhancement of our products.

**General and Administrative Expenses (in thousands)**

|                                     | <b>Three Months Ended</b> |                  | <b>Nine Months Ended</b> |                  |
|-------------------------------------|---------------------------|------------------|--------------------------|------------------|
|                                     | <b>September</b>          | <b>September</b> | <b>September</b>         | <b>September</b> |
|                                     | <b>30,</b>                | <b>30,</b>       | <b>30,</b>               | <b>30,</b>       |
|                                     | <b>2010</b>               | <b>2009</b>      | <b>2010</b>              | <b>2009</b>      |
| General and administrative expenses | \$ 16,658                 | \$ 14,571        | \$ 42,650                | \$ 42,363        |
| As percentage of revenues           | 14%                       | 12%              | 13%                      | 13%              |

General and administrative expenses increased by approximately \$2.1 million and \$0.3 million for the three and nine months ended September 30, 2010 from the comparable period in the prior year, respectively. The increase relates to

payroll related expenses as well as stock-based compensation. The nine month period ended September 30, 2009 includes a provision for bad debts of \$1.2 million related to the Registered Traveler contract. As a percentage of revenues, general and administrative expenses were 14 percent and 13 percent for the three and nine month periods ended September 30, 2010 and 12 and 13 percent for the same periods in the prior year. General and administrative expenses consist primarily of salaries and related personnel costs, including stock-based compensation for our executive and administrative personnel, professional and board of directors fees, public and investor relations and insurance.

**Asset Impairment Charge (in thousands)**

|                         | <b>Three Months Ended</b> |                  | <b>Nine Months Ended</b> |                  |
|-------------------------|---------------------------|------------------|--------------------------|------------------|
|                         | <b>September</b>          | <b>September</b> | <b>September</b>         | <b>September</b> |
|                         | <b>30,</b>                | <b>30,</b>       | <b>30,</b>               | <b>30,</b>       |
|                         | <b>2010</b>               | <b>2009</b>      | <b>2010</b>              | <b>2009</b>      |
| Asset impairment charge | \$ 2,915                  | \$               | \$ 2,915                 | \$               |

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Asset impairment charges of \$2.9 million for both the three and nine months ended September 30, 2010 were due to the unsuccessful negotiations related to our participation in the restart of the Registered Traveler program.

**Strategic Alternative Transactions and Acquisition Related Costs (in thousands)**

|  | <b>Three Months Ended</b> |                  | <b>Nine Months Ended</b> |                  |
|--|---------------------------|------------------|--------------------------|------------------|
|  | <b>September</b>          | <b>September</b> | <b>September</b>         | <b>September</b> |
|  | <b>30,</b>                | <b>30,</b>       | <b>30,</b>               | <b>30,</b>       |
|  | <b>2010</b>               | <b>2009</b>      | <b>2010</b>              | <b>2009</b>      |
| Strategic alternative transactions and acquisition related costs | \$ 6,063                  | \$ 27            | \$ 7,971                 | \$ 506           |

Strategic alternative transactions and other acquisition related costs increased by \$6.0 million and \$7.5 million for the three and nine months ended September 30, 2010 from the comparable period in the prior year, respectively, due to legal and advisory costs incurred in connection with the exploration of strategic alternatives in 2010, and exclude costs attributable to the Intel Business.

**Financing Costs (in thousands)**

|                       | <b>Three Months Ended</b> |                  | <b>Nine Months Ended</b> |                  |
|-----------------------|---------------------------|------------------|--------------------------|------------------|
|                       | <b>September</b>          | <b>September</b> | <b>September</b>         | <b>September</b> |
|                       | <b>30,</b>                | <b>30,</b>       | <b>30,</b>               | <b>30,</b>       |
|                       | <b>2010</b>               | <b>2009</b>      | <b>2010</b>              | <b>2009</b>      |
| Financing costs:      |                           |                  |                          |                  |
| Contractual interest  | \$ (2,515)                | \$ (1,797)       | \$ (7,108)               | \$ (5,674)       |
| Other financing costs | (1,865)                   | (1,871)          | (5,475)                  | (5,191)          |
| Financing costs       | \$ (4,380)                | \$ (3,668)       | \$ (12,583)              | \$ (10,865)      |

For the three and nine months ended September 30, 2010, net financing costs increased by approximately \$0.7 million and \$1.7 million from the comparable period in the prior year, respectively. The increase in both the three and nine month periods ended September 30, 2010 as compared to the comparable period in the prior year is primarily due to interest on borrowings outstanding under the revolving credit facility. Financing costs are presented net of amounts allocated to discontinued operations.

**Other Expense, Net (in thousands)**

|                    | <b>Three Months Ended</b> |                  | <b>Nine Months Ended</b> |                  |
|--------------------|---------------------------|------------------|--------------------------|------------------|
|                    | <b>September</b>          | <b>September</b> | <b>September</b>         | <b>September</b> |
|                    | <b>30,</b>                | <b>30,</b>       | <b>30,</b>               | <b>30,</b>       |
|                    | <b>2010</b>               | <b>2009</b>      | <b>2010</b>              | <b>2009</b>      |
| Other expense, net | \$ (226)                  | \$ (92)          | \$ (404)                 | \$ (47)          |

Other expense, net, includes realized and unrealized gains and losses on foreign currency transactions. The increases in other expense, net, are related primarily to changes in the value of the U.S. dollar relative to the Canadian Dollar and the Japanese Yen during the periods.

**Income Taxes (in thousands)**

|  | <b>Three Months Ended</b> |                  | <b>Nine Months Ended</b> |                  |
|--|---------------------------|------------------|--------------------------|------------------|
|  | <b>September</b>          | <b>September</b> | <b>September</b>         | <b>September</b> |
|  | <b>30,</b>                | <b>30,</b>       | <b>30,</b>               | <b>30,</b>       |
|  | <b>2010</b>               | <b>2009</b>      | <b>2010</b>              | <b>2009</b>      |

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|                                |          |    |         |          |    |       |
|--------------------------------|----------|----|---------|----------|----|-------|
| Income taxes benefit (expense) | \$ 1,899 | \$ | (1,506) | \$ 4,078 | \$ | (168) |
|--------------------------------|----------|----|---------|----------|----|-------|

For the nine months ended September 30, 2010 and 2009 the tax benefit from continuing operations was \$4.1 million and a provision of \$0.2 million, respectively and the pre-tax loss was \$19.0 million and \$0.8 million, respectively. The tax benefit from discontinued operations for the nine months ended September 30, 2010 and 2009 was \$2.2 million and \$1.6 million, respectively. The tax benefit was allocated between continued and discontinued operations by first calculating the provision on a consolidated basis including discontinued operations and then calculating the provision excluding discontinued operations. The difference between the two calculations was then allocated to the discontinued operations.

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The tax benefit is based on an estimated annual effective tax rate applied to the cumulative year to date results for both periods. Separate annual effective tax rates were used for entities that file returns on a separate company basis and expect to report losses for the full year, which have an estimated annual effective tax rate of 0%. The remaining entities included in the condensed consolidated financial statements have estimated annual effective tax rates of 34% and 39% for the nine months ended September 30, 2010 and 2009. The provision for the nine months ended September 30, 2010 also reflects the impact of the discrete items, (including transactions costs associated with the sale of the Company), which are not deductible for federal income tax purposes.

In connection with the sale of the Intel Business, the Company expects to recognize a significant gain for financial and tax reporting purposes which is estimated to result in current tax liability of approximately \$20.0 million. The tax effects of the sale will be reflected as discrete items in the period during which the sale is consummated.

**Comprehensive Income (Loss) (in thousands)**

|  | <b>Three Months Ended</b>         |                                   | <b>Nine Months Ended</b>          |                                   |
|--|-----------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|
|  | <b>September<br/>30,<br/>2010</b> | <b>September<br/>30,<br/>2009</b> | <b>September<br/>30,<br/>2010</b> | <b>September<br/>30,<br/>2009</b> |
| Net income (loss)                                  | \$ (9,175)                        | \$ 1,372                          | \$ (19,412)                       | \$ (3,658)                        |
| Changes in accumulated comprehensive income (loss) | 1,611                             | 963                               | (52)                              | 1,769                             |
| Comprehensive income (loss)                        | \$ (7,564)                        | \$ 2,335                          | \$ (19,464)                       | \$ (1,889)                        |

The change in comprehensive loss results from the net loss for the three and nine months ended September 30, 2010 of \$9.2 million and \$19.4 million, respectively, compared to net income of \$1.4 million and net loss of \$3.7 million in the prior year period, changes in the fair value and amortization of derivatives accounted for as hedges which resulted in year to date gains of \$0.2 million and \$0.6 million in 2010 and 2009, respectively, and year to date translation losses of \$0.3 million in 2010 and gains of \$1.2 million in 2009, resulting from the changes in the value of the U.S. dollar relative to foreign currencies, primarily the Euro and the Canadian Dollar.

**LIQUIDITY AND CAPITAL RESOURCES****Capital Requirements**

L-1's most significant capital requirements consist of capital expenditures for new secure credentialing contracts, research and development and working capital needs. The most significant capital expenditures are related to our Solutions segment. When we bid on new state drivers' license contracts, we must commit to provide up front capital expenditures in order to install systems necessary to perform under the contract. Accordingly, our capital requirements increase as we bid on and are awarded new contracts or as contracts are renewed. During the nine months ended September 30, 2010 and 2009, our capital expenditures were \$32.6 million compared to \$38.4 million, respectively. In the year ended December 31, 2009, capital expenditures approximated \$55.0 million and are expected to be in the range of \$40.0 million to \$45.0 million for the year ending December 31, 2010, primarily related to performance requirements under new contract awards in our secure credentialing business. L-1 expects to fund its capital requirements primarily with operating cash flows and borrowings under the revolving credit facility, and may consider an equipment financing transactions if favorable terms are available.

**Liquidity**

We expect that the sale of the Intel Business, currently expected in the fourth quarter of 2010, will generate net cash proceeds of \$290.0 million of which \$270.0 million will be applied to the reduction of debt, as described below. Pursuant to the terms of the Credit Agreement, as amended, the Company is required to use the Net Cash Proceeds (as defined) from the sale of the Intel Business to BAE to the reduction of amounts borrowed under the Credit Agreement first in reduction to the Term Loans and next in reduction of revolving loans.



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The estimated Net Cash Proceeds, as defined, approximate \$270.0 million which exceeds the aggregate principal amounts of the Term Loans as of September 30, 2010. Because the related assets held for sale and corresponding liabilities are included in current assets and liabilities, the \$269.0 million, the total amount outstanding under the Term Loans, net of original discount and \$1.0 million of borrowings under the revolving credit facility has been included in current liabilities.

As of September 30, 2010, we had \$6.0 million of negative working capital including assets held for sale of \$262.6 million, related liabilities of \$37.0 million and current maturities of long term debt of \$268.3 million, deferred income tax assets of \$9.8 million and cash and cash equivalents of \$9.0 million. In addition, we have financing arrangements, as further described below, available to support our ongoing liquidity needs, pursuant to which we have available \$92.0 million at September 30, 2010 subject to continuing compliance with our debt covenants. L-1 believes that our existing cash and cash equivalent balances, existing financing arrangements and cash flows from operations will be sufficient to meet our operating and debt service requirements for the next 12 months. We expect that the sale of the Intel Business and the sale of the Company will result in the repayment of substantially all existing debt of the Company excluding the Convertible Notes. However, if these transactions were not consummated, it is likely that we will require additional financing to improve our liquidity and in that connection, we evaluate financing needs and the terms and conditions and availability under our credit facility on a regular basis and consider other financing options. L-1 may also pursue reduction of our current indebtedness if equity financing can be obtained on advantageous terms and may take other actions to improve liquidity. There can be no assurance that additional debt or equity financing will be available or that other actions can be taken on commercially reasonable terms, or at all. L-1's ability to meet our business plan is dependent on a number of factors, including those described in the section of this report entitled Risk Factors and those described in our Annual Report on Form 10-K for the year ended December 31, 2009.

***Credit Agreement***

On August 5, 2008, L-1 entered into a Second Amended and Restated Credit Agreement (the Credit Agreement), among L-1's wholly owned subsidiary L-1 Identity Operating, L-1, Bank of America, N.A., Wachovia Bank, National Association, Banc of America Securities LLC and Wachovia Capital Markets LLC, to amend and restate the Amended and Restated Credit Agreement, by and among L-1, Bank of America, N.A. (Administrative Agent), Bear Stearns Corporate Lending, Inc., Bear Stearns & Co., Inc., Banc of America Securities LLC, Wachovia Bank, N.A. and Credit Suisse, Cayman Islands Branch. The Credit Agreement provides for a senior secured term loan facility in an aggregate principal amount of up to \$300.0 million, with a term of five years, and a senior secured revolving credit facility in an aggregate principal amount of up to \$135.0 million. The proceeds of the senior secured facilities were used to (i) fund, in part, the purchase price paid, and fees and expenses incurred, in connection with L-1's acquisition of Digimarc Corporation after giving effect to the spin-off of its digital watermarking business (Old Digimarc), (ii) repay borrowings under L-1's then existing revolving credit facility and (iii) provide ongoing working capital and fund other general corporate purposes of L-1. As of September 30, 2010, the Company has approximately \$92.0 million available under its revolving credit facility, subject to continuing compliance with covenants under the credit agreement.

On July 9, 2009, L-1 entered into an amendment to the Credit Agreement pursuant to which the term loans under the Credit Agreement have been split into two tranches: the Tranche B-1 Term Loan and the Tranche B-2 Term Loan. The Tranche B-1 Term Loan, with an aggregate principal amount of approximately \$136.5 million at September 30, 2010, requires annual principal payments (payable quarterly) of 10 percent of the original principal amount through September 30, 2010, 20 percent of the original principal amount through September 30, 2012, and thereafter, increasing over the duration of the Credit Agreement. The Tranche B-2 Term Loan, with an aggregate principal amount of approximately \$132.5 million at September 30, 2010, requires annual principal payments (also payable quarterly) of 1 percent of the related original principal amounts over the remaining term of the Credit Agreement. At September 30, 2010, there were \$35.0 million of borrowings that were outstanding under the revolving credit facility.

Under the terms of the amended senior secured credit facility, the Company has the option to borrow at LIBOR (subject to a floor of 3 percent) plus 2.75 percent to 5.0 percent per annum or at prime (subject to a floor of 2 percent) plus 1.75 percent to 4.0 percent per annum. L-1 is required to pay a fee of 0.5 percent on the unused portion of the revolving credit facility. All obligations of L-1 Operating under the Credit Agreement are guaranteed on a senior

secured basis by L-1 and by each of L-1's existing and subsequently acquired or organized direct or indirect wholly-owned subsidiaries (subject to certain exceptions). At September 30, 2010, the interest rates were 6.75 percent for Tranche B-1 Term Loans, 7.25 percent for Tranche B-2 Term Loans and 6.0 percent for borrowings under the revolving credit facility.

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L-1 is required to maintain the following financial covenants under the Credit Agreement:

**Consolidated Debt Service Coverage Ratio.** As of the end of any fiscal quarter, the ratio of Consolidated EBITDA (as defined in the Credit Agreement) of L-1 Operating and its consolidated subsidiaries for the period of four consecutive fiscal quarters ending on or immediately prior to such date to the sum of (i) Consolidated Interest Charges (as defined in the Credit Agreement) of L-1 Operating and its consolidated subsidiaries paid or payable in cash during the period of four consecutive fiscal quarters ended on or immediately prior to such date, plus (ii) Consolidated Debt Amortization (as defined in the Credit Agreement) of L-1 Operating and its consolidated subsidiaries as of such date, shall not be less than 2.25:1.00. These financial covenants have been amended as described below.

**Consolidated Debt Coverage Ratio.** As of the end of any fiscal quarter, the ratio of L-1 Operating's Consolidated Funded Indebtedness (as defined in the Credit Agreement which excludes standby letters of credit issued in connection with performance bonds) as of such date to its Consolidated EBITDA (as defined in the Credit Agreement) for the period of four consecutive fiscal quarters ended on or immediately prior to such date, may not be more than: (i) 3.25:1.00 from the Closing Date (as defined in the Credit Agreement) to and including March 30, 2010, (ii) 3.00:1.00 from March 31, 2010 to March 30, 2011, and (iii) 2.75:1.00 at the end of each fiscal quarter thereafter. These financial covenants have been amended as described below.

On August 30, 2010, L-1 entered into an amendment and consent (the "Third Amendment") to the Second Amended and Restated Credit Agreement dated as of August 5, 2008, among L-1 Identity Solutions Operating Company, the Company, Bank of America, N.A., the Lenders party thereto, Wachovia Bank, National Association, Banc of America Securities LLC and Wachovia Capital Markets LLC (as amended, the "Credit Agreement"). The Third Amendment extends the time period during which previously modified financial covenants will apply under the Credit Agreement, subject to the Company entering into definitive agreements providing for the sale of all or substantially all of the assets and operations of the Company and its subsidiaries in connection with its strategic alternatives review by September 30, 2010, which the Company executed on September 19, 2010. The Third Amendment provides that the minimum Consolidated Debt Service Coverage Ratio of 1.65 to 1.00 will remain in effect for the third fiscal quarter of 2010 and the period through and including March 30, 2011, after which the minimum Consolidated Debt Service Coverage Ratio shall return to 2.25 to 1.00 for each fiscal quarter thereafter, and the maximum Consolidated Leverage Ratio of 3.85 to 1.00 remain in effect for the third fiscal quarter of 2010 and the period through and including March 30, 2011, after which the maximum Consolidated Leverage Ratio shall return to 2.75 to 1.00 for each fiscal quarter thereafter. At September 30, 2010 the Company's Consolidated Debt Service Coverage Ratio was 2.00:1.00 and the Consolidated Leverage Ratio was 3.25:1.00; accordingly the Company was in compliance with the modified financial covenants.

Under the terms of the Credit Agreement, as amended, L-1 Operating may incur, assume or guarantee unsecured subordinated indebtedness in an amount up to \$200.0 million, provided that no default or event of default shall have occurred or would occur as a result of the incurrence of such subordinated debt and the borrower and its subsidiaries are in pro forma compliance, after giving effect to the incurrence of such subordinated debt, with each of the covenants in the Credit Agreement, including, without limitation, the financial covenants described above.

Pursuant to the terms of the Credit Agreement, as amended, L-1 may incur, assume or guarantee any amount of unsecured subordinated indebtedness, provided, that no default or event of default shall have occurred or would occur as a result of the incurrence of such subordinated debt and the pro forma Consolidated Leverage Ratio (as defined in the Credit Agreement) of L-1 and its subsidiaries after giving effect to the incurrence of such subordinated debt shall be less than 4.75:1.00. The Credit Agreement limits the ability of L-1 to (i) pay dividends or other distributions or repurchase capital stock, (ii) create, incur, assume or suffer to exist any indebtedness, (iii) create, incur, assume or suffer to exist liens upon any of its property, assets or revenues, (iv) sell, transfer, license, lease or otherwise dispose of any property, (v) make or become legally obligated to make capital expenditures above certain thresholds, subject to certain permitted adjustments, (vi) make investments, including acquisitions, and (vii) enter into transactions with affiliates. These covenants are subject to a number of exceptions and qualifications. The Credit Agreement provides for customary events of default which include (subject in certain cases to customary grace and cure periods), among others: nonpayment, breach of covenants or other agreements in the Credit Agreement or the other Loan Documents

(as defined in the Credit Agreement), payment defaults or acceleration of other indebtedness, failure to pay certain judgments, inability to pay debts as they become due and certain events of bankruptcy, insolvency or reorganization.

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If an event of default, including a change in control (as defined in the Credit Agreement) occurs, the Administrative Agent may, with the consent of the Required Lenders declare all outstanding indebtedness including accrued and unpaid interest under the Credit Agreement to be due and payable.

The Company has entered into interest rate protection agreements to reduce its exposure to the variable interest rate payments on its term loan. In October 2008, the Company entered into an interest rate protection agreement with a notional amount of \$62.5 million, which expires in November, 2011. Under the term of the agreement, the Company pays the counter party a fixed rate of 4.1 percent and receives variable interest based on three-month LIBOR (subject to a floor of 3.0 percent). In May 2009, the Company entered into two additional interest rate protection agreements with notional amounts of \$50.0 million each, pursuant to which the Company pays a fixed rate of 1.4 percent and receives three month LIBOR. The counterparties to these agreements are highly rated financial institutions. In the unlikely event that the counterparties fail to meet the terms of the interest rate swap agreement, the Company's exposure is limited to the interest rate differential on the notional amount at each quarterly settlement period over the life of the agreements. L-1 does not anticipate non-performance by the counterparties.

### ***Convertible Senior Notes***

On May 17, 2007, the Company issued \$175.0 million of Convertible Notes with a conversion feature which allows the Company the option to settle the debt either in shares of common stock or to settle the principal amount in cash and the conversion spread in cash or stock. The proceeds of the Convertible Notes offering, net of deferred financing costs amounted to \$168.7 million. In connection with the issuance of the Convertible Notes, L-1 entered into an agreement with Bear Stearns (now JP Morgan Chase) to purchase approximately 3.5 million shares of L-1's common stock for approximately \$69.8 million. The shares will be delivered in May 2012; however, L-1 settled its obligation at closing for a cash payment.

The Notes are governed by an indenture, dated May 17, 2007 (the "Indenture"), between the Company and the trustee. The Notes will be convertible only under certain circumstances, as described below. If, at the time of conversion, the daily volume-weighted average price per share for a 25 trading day period calculated in accordance with the Indenture (as defined in greater detail in the Indenture, "VWAP") of the Company's common stock is less than or equal to \$32.00 per share, which is referred to as the base conversion price, the Notes will be convertible into 31.25 shares of common stock of the Company per \$1,000 principal amount of the Notes, subject to adjustment upon the occurrence of certain events. If, at the time of conversion, the VWAP of the shares of common stock of the Company exceeds the base conversion price of \$32.00 per share, the conversion rate will be determined pursuant to a formula resulting in holders' receipt of up to an additional 14 shares of common stock per \$1,000 principal amount of the Notes, subject to adjustment upon the occurrence of certain events and determined as set forth in the Indenture. As an example, if the volume-weighted price per share (VWAP) of the Company stock were to increase to \$40.00 per share, the additional shares issuable upon conversion would be 2.8, and the shares issuable per \$1,000 principal amount of the Notes would be 34.05.

The Notes are convertible until the close of business on the second business day immediately preceding May 15, 2027, in multiples of \$1,000 in principal amount, at the option of the holder under the following circumstances: (1) during the five business-day period after any five consecutive trading day period (the "measurement period") in which the trading price per Note, for each day of such measurement period was less than 98 percent of the product of the last reported sale price of shares of common stock of the Company and the applicable conversion rate for such trading day; (2) during any fiscal quarter, if the last reported sale price of shares of common stock of the Company for 20 or more trading days in a period of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter is greater than or equal to 130 percent of the base conversion price on the related trading day; (3) if the Company calls any or all of the Notes for redemption; and (4) upon the occurrence of specified corporate transactions described in the Indenture, including for a specified period of time prior to a change in control transaction. Upon conversion, the Company has the right to deliver shares of common stock based upon the applicable conversion rate, or a combination of cash and shares of common stock, if any, based on a daily conversion value as described above calculated on a proportionate basis for each trading day of a 25 trading-day observation period. In the event of a fundamental change as specified in the Indenture, which includes a change in control transaction, the Company will increase the conversion rate by a number of additional shares of common stock specified in the

Indenture, or, in lieu thereof, the Company may in certain circumstances elect to adjust the conversion rate and related conversion obligation so that the Notes will become convertible into shares of the acquiring or surviving Company. In connection with the Safran merger, the Company expects to deliver a conversion notice no later than 35 days prior to the anticipated closing date, and expects that the conversion price will be equal to the base conversion price. The Notes will not become convertible into shares of Safran in connection with the merger.

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The Notes bear interest at a rate of 3.75 percent per year payable semiannually in arrears in cash on May 15 and November 15. The Notes will mature on May 15, 2027, unless earlier converted, redeemed or repurchased. The Company may redeem the Notes at its option, in whole or in part, on or after May 20, 2012, subject to prior notice as provided in the Indenture. The redemption price during that period will be equal to the principal amount of the notes to be redeemed, plus any accrued and unpaid interest. The holders may require the Company to repurchase the Notes for cash on May 15, 2012, May 15, 2017 and May 15, 2020.

Upon consummation of any share exchange, consolidation or merger of L-1 pursuant to which its common stock will be converted into cash, securities or other property or any sale, lease or other transfer in one transaction or a series of transactions of all or substantially all of L-1's and L-1's subsidiaries' assets, taken as a whole, to any person other than one of its subsidiaries, the holders of the Convertible Notes can require the Company to convert or to repurchase all outstanding debt at a purchase price equal to 100 percent of the principal amount plus accrued and unpaid interest. It is expected that the holders of the Notes will exercise their rights to require the Company to purchase the Notes upon closing of the consummation of the merger of the Company with Safran.

|   | <b>Nine Months Ended</b>          |                                   |
|---|-----------------------------------|-----------------------------------|
|   | <b>September<br/>30,<br/>2010</b> | <b>September<br/>30,<br/>2009</b> |
| <b>Consolidated Cash Flows</b> (in thousands)         |                                   |                                   |
| Net cash provided by (used in):                       |                                   |                                   |
| Operating activities                                  | \$ 27,651                         | \$ 47,746                         |
| Investing activities                                  | (42,194)                          | (47,869)                          |
| Financing activities                                  | 16,770                            | (9,475)                           |
| Effect of exchange rates on cash and cash equivalents | 175                               | 200                               |
| Net increase (decrease) in cash and cash equivalents  | \$ 2,402                          | \$ (9,398)                        |

Cash flows from operating activities including discontinued operations, decreased by approximately \$20.1 million for the nine months ended September 30, 2010 as compared to the corresponding period of the prior year. Net loss for the nine months ended September 30, 2010 was \$19.4 million and includes non-cash charges of \$31.4 million for depreciation and amortization, \$18.0 million for stock-based compensation and retirement contributions settled or to be settled in common stock, \$9.0 million for amortization of deferred financing costs, debt discount and other, \$6.3 million for non-cash income tax benefit, and \$2.9 million of asset impairments. Operating cash flows reflect the impact in accruals and deferrals related to operating assets and liabilities which had an adverse impact on cash flows of \$7.9 million and \$1.2 million for the nine months ended September 30, 2010 and 2009, respectively. Capital expenditures were approximately \$32.6 million and \$38.4 million for the nine months ended September 30, 2010 and 2009, respectively, and are primarily related to our drivers' licenses product line, also during the nine months ended September 30, 2010, L-1 acquired certain assets of Retica Systems for cash of \$2.6 million. Net cash provided by financing activities in 2010 was \$16.8 million compared to net cash used in financing activities of \$9.5 million in 2009. L-1 borrowed \$61.2 million for the nine months ended September 30, 2010 and had no borrowings in the same period of the prior year. L-1 repaid \$13.1 million of the term loan borrowings and \$31.7 million of the revolving credit borrowings and other debt in 2010 compared to \$9.8 million in payments for the term loan in the same period in the prior year.

**Working Capital**

As a result of the Company accounting for the Intel Business as discontinued operations, working capital includes assets held for sale of \$262.6 million and related liabilities of \$37.0 million. In addition, working capital includes current maturities of long-term debt of \$268.3 million representing the carrying amount of debt expected to be repaid from the proceeds of the sale of the Intel Business.





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Accounts receivable, including \$34.3 million classified as assets held for sale, increased by approximately \$7.6 million as of September 30, 2010, from December 31, 2009. Days sales outstanding were 65 days at September 30, 2010 and 67 days at December 31, 2009. Accounts receivable are presented net of an allowance for doubtful accounts of \$4.9 million and \$4.9 million at September 30, 2010 and December 31, 2009, respectively. At December 31, 2009, the allowance reflects additions recorded in 2009 for the suspension of the Registered Traveler program of approximately \$1.2 million as well as approximately \$2.8 million for estimated unrecoverable amounts related to enrollment services programs that started in 2009. During 2010, the net receivable related to the Registered Traveler program was written off and the allowance was increased for additional exposures for bad debts.

Inventory increased by \$5.6 million as of September 30, 2010, compared to December 31, 2009, primarily to meet expected shipments for various state programs in our credentialing and biometrics businesses and the acquisition of Retica inventory in 2010. Inventory reflects the levels required to meet expected deliveries of our credentialing and biometric solutions.

Accounts payable, accrued expenses and other current liabilities including \$23.6 million included in liabilities related to discontinued operations, increased by \$2.1 million as of September 30, 2010, compared to December 31, 2009, reflecting, liabilities and accruals of approximately \$9.0 million related to strategic alternative transaction costs, offset by lower benefit accruals which are settled in subsequent periods, as well as timing of invoice payments.

Total deferred revenue decreased by \$2.5 million as of September 30, 2010, compared to December 31, 2009, reflecting the impact of higher maintenance renewals in the 2009 compared to 2010, as well as a result of recognizing revenue on transactions that met the revenue recognition criteria during the nine months ended September 30, 2010.

**CONTRACTUAL OBLIGATIONS**

The following table sets forth L-1's contractual obligations as of September 30, 2010 (in thousands):

|                                    | <b>Total</b> | <b>Less than<br/>1 Year</b> | <b>2-3 Years</b> | <b>3-5 Years</b> | <b>More than<br/>5<br/>Years</b> |
|------------------------------------|--------------|-----------------------------|------------------|------------------|----------------------------------|
| <b>Continuing Operations:</b>      |              |                             |                  |                  |                                  |
| Operating lease obligations        | \$ 25,273    | \$ 2,000                    | \$ 11,104        | \$9,040          | \$ 3,129                         |
| Debt and capital lease obligations | \$497,698    | \$311,205                   | \$186,091        | \$ 402           | \$                               |

**Discontinued Operations:**

|                             |          |        |          |        |        |
|-----------------------------|----------|--------|----------|--------|--------|
| Operating lease obligations | \$ 3,139 | \$ 313 | \$ 2,144 | \$ 335 | \$ 347 |
|-----------------------------|----------|--------|----------|--------|--------|

Included in debt are \$175.0 million outstanding under L-1's Convertible Notes which bears interest at 3.75 percent and \$269.0 million in term loans of which Tranche B-1 bears interest at 6.75 percent and Tranche B-2 bears interest at 7.25 percent and the revolving credit loans of \$35.0 million which bears interest at 6.0 percent. The amounts shown above include interest and assume that the Convertible Notes are redeemed at the end of five years, in 2012 but the Notes are expected to be repaid in connection with the sale of the Company to Safran SA. The table also reflects the repayment of the term loans in 2010.

The Company has consulting agreements with two formerly related parties under which each receives annual compensation of \$0.1 million through the earlier of January 2012 or commencement of full time employment elsewhere. In addition, the Company is subject to a royalty arrangement with a related party whereby the Company is subject to royalty payments on certain of its face recognition software revenue through June 30, 2014, up to a maximum \$27.5 million.

In connection with the merger with Identix, Aston Capital Partners, LLC, an affiliated company, and L-1 have agreed in principle that the Company may, subject to the approval of the Board of Directors, purchase AFIX Technologies, Inc., a portfolio company of Aston, at fair market value to be determined by an independent appraiser retained by the Company's Board of Directors. In March 2009, L-1 concluded that due to a variety of factors, it was not advisable to pursue the transaction to purchase AFIX at that point in time.

**CONTINGENT OBLIGATIONS**



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L-1 has no material contingent obligations at September 30, 2010.

### **INFLATION**

Although some of L-1's expenses increase with general inflation in the economy, inflation has not had a material impact on L-1's financial results to date.

### **CRITICAL ACCOUNTING POLICIES AND SIGNIFICANT ESTIMATES**

L-1 prepares its consolidated financial statements in accordance with accounting principles generally accepted in the United States of America, or U.S. GAAP. Consistent with U.S. GAAP, L-1 has adopted accounting policies that L-1 believes are most appropriate given the conditions and circumstances of L-1's business. Some of these policies require management to make assumptions and estimates. These assumptions and estimates, which are based on historical experience and analyses of current conditions and circumstances, have a significant impact on L-1's reported results of operations and assets and liabilities and disclosures of contingent assets and liabilities. The most significant assumptions and estimates relate to the allocation of purchase price of the acquired businesses, assessing the impairment of goodwill, other intangible assets and property and equipment, revenue recognition, income taxes, contingencies, litigation and valuation of financial instruments, including warrants and stock options. If actual results differ significantly from the estimates reflected in the financial statements, there could be a material effect on L-1's consolidated financial statements.

Reference is made to L-1's Annual Report on Form 10-K for a discussion of critical accounting policies. There have been no material changes to such policies, except as discussed in the Notes to the Financial Statements included in this Quarterly Report of the Form 10-Q related to the adoption of recently adopted accounting standards, and accounting for the Intel Business as discontinued operations.

### **ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK**

#### **INTEREST RATE RISK**

L-1 is exposed to interest rate risk related to borrowings under L-1's Credit Agreement. At September 30, 2010, borrowings outstanding under the Credit Agreement aggregated \$304.0 million, bearing interest at variable rates. At September 30, 2010, the estimated market value of the Term Loan was approximately \$269.4 million and the carrying amount was \$269.0 million. The Company is exposed to risks resulting from increases in interest rates and benefits from decreasing interest rates subject to floors as described in the Credit Agreement. A change in the interest rate of 1 percent would increase or decrease interest expense by \$3.0 million. The Company has partially mitigated this interest rate risk by entering into interest rate protection agreements with an aggregate notional amount of \$162.5 million pursuant to which it receives variable interest based on three month LIBOR, subject to a floor of 3.0 percent with respect to \$62.5 million notional amount and pays a fixed interest rate.

L-1's Convertible Notes bear interest at a fixed rate and mature on May 15, 2027, but can be redeemed by us or called by the holders in May 2012 and are convertible into shares of L-1 common stock at an initial conversion price of \$32.00 (31.25 shares per \$1,000 principal amount) in the following circumstances:

If during any five consecutive trading day period the trading price is less than 98 percent of the product of the last reported sales price multiplied by the applicable conversion rate.

After September 30, 2010, if the sale price of L-1 common stock for twenty or more trading days exceeds 130 percent of the initial conversion price.

If the Company calls the Convertible Notes for redemption or upon certain specified transactions.

Upon consummation of the sale of the Company to Safran SA, the holders of the Convertible Notes have the option to require payment in cash at the stated principal amount plus accrued interest. We expect that the holders will exercise this option.

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The market value of the Convertible Notes is impacted by changes in interest rates and changes in the market value of L-1 common stock. At September 30, 2010, the estimated market value of the Convertible Notes was approximately \$174.8 million and the carrying amount was \$165.2 million.

For additional information regarding debt and financing instruments see Notes 4 and 6 to our consolidated financial statements.

### **FOREIGN CURRENCY EXPOSURES**

The transactions of L-1's international operations, primarily our Germany, Canadian and Mexican subsidiaries, are denominated in Euros, Canadian Dollars, and Mexican Pesos, respectively. Financial assets and liabilities denominated in foreign currencies consist primarily of accounts receivable, accounts payable and accrued expenses. At September 30, 2010, financial assets and liabilities denominated in Euros aggregated \$0.5 million and \$0.1 million, respectively, and at September 30, 2009, aggregated \$2.2 million and \$1.3 million, respectively. At September 30, 2010, financial assets and liabilities denominated in Canadian Dollars aggregated \$2.0 million and \$2.2 million, respectively, and at September 30, 2009, aggregated \$3.8 million and \$2.2 million, respectively. At September 30, 2010, financial assets and liabilities denominated in Mexican Pesos were \$1.2 million and \$0.5 million, respectively, and at September 30, 2009, aggregated \$1.2 million and \$0.3 million, respectively.

Hardware and consumable purchases related to contracts with the U.S. Department of State are denominated in Japanese Yen and the Company's costs and operations are exposed to changes in the value of the Yen since the related revenues are fixed in U.S. dollars. At September 30, 2010, these Japanese Yen denominated liabilities were \$0.7 million. At September 30, 2009, there were no Japanese Yen denominated liabilities. L-1 uses foreign currency forward contracts as economic hedges to limit exposure to Yen denominated liabilities. All gains and losses resulting from the change in fair value of these foreign currency forward contracts are recorded in operations and offset unrealized gains and losses related to recorded liabilities. None of the contracts were terminated prior to settlement. As of September 30, 2010, the Company had committed to one foreign currency forward contract that mitigates approximately \$0.6 million of foreign currency exposures for the liabilities denominated in Yen. The company had no foreign currency contracts at September 30, 2009. The fair value of these contracts at September 30, 2010 was an unrealized loss of less than \$0.1 million.

L-1 also has entered into a contract to deliver solutions, hardware and maintenance which is denominated in Saudi Riyals for approximately \$22.4 million at September 30, 2010. The Saudi Riyal is currently pegged to the U.S. Dollar at a rate of 3.75 Riyal for each U.S. Dollar.

L-1's international operations and transactions are subject to risks typical of international operations, including, but not limited to, differing economic conditions, changes in political climate, differing tax structures, other regulations and restrictions and foreign currency exchange rate volatility. Accordingly, L-1's future results could be materially impacted by changes in these or other factors. L-1's principal exposure is related to subsidiaries whose revenues costs and assets and liabilities denominated in Euros, Japanese Yen, Canadian Dollars and Mexican Pesos. As of September 30, 2010, the cumulative effect from foreign currency translation adjustments related to foreign operations was approximately gains of \$0.7 million.

### **PREPAID FORWARD CONTRACT**

L-1 has entered into a pre-paid forward contract with Bear Stearns (now JP Morgan Chase) to purchase approximately 3.5 million shares of our common stock at a price of \$20.00 per share for delivery in May 2012. However, L-1 settled the obligation with a cash payment at closing. The price of the common stock at the time of delivery may be higher or lower than \$20.00. The transaction is subject to early settlement or settlement with alternative consideration in the event of certain significant corporate transactions such as a change in control (which would include the consummation of the merger with Safran).

## **ITEM 4 CONTROLS AND PROCEDURES**

(a) *Evaluation of disclosure controls and procedures.*

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L-1 has established and maintains disclosure controls and procedures that are designed to ensure that material information relating to L-1 and its subsidiaries required to be disclosed by us in our reports under the Securities Exchange Act of 1934, as amended, or the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to L-1's management, including the Company's Chief Executive Officer, or CEO, and Chief Financial Officer, or CFO, as appropriate to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure control and procedures, management recognizes that any control and procedure, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, as L-1 is designed to do, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

In connection with the preparation of this Quarterly Report on Form 10-Q, an evaluation under the supervision and with the participation of L-1's management, including the CEO and CFO, of the effectiveness of the design and operation of L-1's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) was performed as of September 30, 2010. Based on this evaluation, L-1's CEO and CFO concluded that our disclosure controls and procedures were effective at a reasonable assurance level as of September 30, 2010.

### ***(b) Changes in Internal Controls over Financial Reporting***

In the normal course, L-1 reviews and changes internal controls to reflect changes in business and operations and enhances and modifies controls in response to these changes on an ongoing basis. There have been no changes in L-1's internal control over financial reporting that occurred during the quarter ended September 30, 2010 that have materially affected, or are reasonably likely to materially affect, L-1's internal controls over financial reporting.

The certifications of L-1's principal executive officer and principal financial officer required in accordance with Rule 13a-14(a) and 15-d-14(a) under the Exchange Act are attached as exhibits to this Quarterly Report on Form 10-Q. The disclosures set forth in this Item 4 contain information concerning the evaluation of L-1's disclosure controls and procedures, and changes in L-1's internal control over financial reporting, referred to in paragraph 4 of those certifications. The certifications should be read in conjunction with this Item 4 for a more complete understanding of the matters covered by the certifications.

## **PART II OTHER INFORMATION**

### **ITEM 1 LEGAL PROCEEDINGS**

#### ***Putative Shareholder Class Action Litigation***

The Company has been named as a defendant in five putative shareholder class actions filed in the Superior Court of Connecticut, Judicial District of Stamford-Norwalk at Stamford, arising out of the proposed transactions with Safran and BAE pursuant to the Merger Agreement and BAE Purchase Agreement. The actions are captioned: *Michael Palma v. Robert LaPenta et al.*, CV-10-6006781-S (Conn. Super. Ct.), *Barry P. Kranz, Jr. v. L-1 Identity Solutions et al.*, CV-10-6006760-S (Conn. Super. Ct.), *Michael Matteo v. L-1 Identity Solutions et al.*, CV-10-6006759-S (Conn. Super. Ct.), *Dart Seasonal Products Retirement Plan v. L-1 Identity Solutions et al.*, CV-10-6006835-S (Conn. Super. Ct.), and *George F. Chrisman v. Robert LaPenta et al.*, CV-10-6006886-S (Conn. Super. Ct.) (collectively, the Shareholder Actions).

The plaintiffs in the Shareholder Actions generally allege the members of the L-1 Board of Directors and certain officers of the Company breached their fiduciary duties to shareholders by, among other things, allegedly failing to receive maximum value for their shares, failing to conduct an appropriate sale process and agreeing to certain terms in the proposed merger agreement with Safran that allegedly discourage competing offers from other potential bidders and/or benefit defendants. The Shareholder Actions generally allege that the Company aided and abetted these alleged breaches of fiduciary duty. Certain of the suits also allege claims against Safran, Merger Sub, BAE and BAE Systems, Inc. (the parent entity to BAE and the U.S. affiliate of BAE Systems plc) for aiding and abetting the foregoing alleged breaches of fiduciary duty. The Shareholder Actions generally seek preliminary and permanent relief, including, among other things, permission to proceed as a class action, declaratory relief declaring that defendants have breached their fiduciary duties, an injunction enjoining the transactions contemplated by the Merger Agreement and BAE Purchase Agreement, rescissory damages in the event that the Transactions are consummated, costs and attorneys' fees.



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The Company believes the lawsuits are without merit and intends to vigorously defend against them. As of the date of this Form 10-Q, the Company's time to respond to the complaints has not yet expired.

### *Old Digimarc Litigation*

In connection with the Company's August 2008 acquisition of Old Digimarc, which consisted of its Secure ID Business following the spin-off of its digital watermarking business, the Company assumed certain legal proceedings of Old Digimarc as described below.

Beginning in May 2001, a number of substantially identical class action complaints alleging violations of the federal securities laws were filed in the United States District Court for the Southern District of New York naming approximately 300 companies, including Old Digimarc, certain officers and directors and certain underwriters of the companies' initial public offerings as defendants. The complaints were subsequently consolidated into a single action, and a consolidated amended complaint was filed in April 2002. The amended complaint alleges, among other things, that the underwriters of Old Digimarc's initial public offering violated securities laws by failing to disclose certain alleged compensation arrangements in Old Digimarc's initial public offering registration statement and by engaging in manipulative practices to artificially inflate the price of Old Digimarc's stock in the aftermarket subsequent to the initial public offering. Old Digimarc and certain of its officers and directors are named in the amended complaint pursuant to Section 11 of the Securities Act of 1933 and Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 on the basis of an alleged failure to disclose the underwriters' alleged compensation arrangements and manipulative practices. The complaint sought unspecified damages. In July 2002, the claims against Old Digimarc under Section 10(b) were dismissed. In October 2002, the individual officer and director defendants were dismissed without prejudice pursuant to tolling agreements. Subsequent addenda to these tolling agreements extended the tolling period through August 27, 2010. In June 2004, a stipulation of partial settlement among the plaintiffs, the companies, and the officers and directors was submitted to the District Court. While the partial settlement was pending approval, the plaintiffs continued to litigate their claims against the underwriter defendants. The district court directed that the litigation proceed within a number of focus cases rather than in all of the 309 cases that have now been consolidated. Old Digimarc was not one of these focus cases. In October 2004, the district court certified the focus cases as class actions. The underwriter defendants appealed that ruling and, on December 5, 2006, the Court of Appeals for the Second Circuit reversed the district court's class certification decision for the six focus cases. In light of the Second Circuit opinion, in June 2007, the district court entered an order terminating the settlement. On August 14, 2007, the plaintiffs filed their second consolidated amended class action complaints against the focus cases and on September 27, 2007, again moved for class certification. On November 12, 2007, certain of the defendants in the focus cases moved to dismiss the second consolidated amended class action complaints. The court issued an opinion and order on March 26, 2008, denying the motions to dismiss except as to Section 11 claims raised by those plaintiffs who sold their securities for a price in excess of the initial offering price and those who purchased outside the previously certified class period. The class certification motion was withdrawn without prejudice on October 10, 2008. On April 2, 2009, a stipulation and agreement of settlement among the plaintiffs, issuer defendants (including Old Digimarc) and underwriter defendants was submitted to the Court for preliminary approval. Old Digimarc's portion of the settlement, which is wholly immaterial, is covered entirely by insurance.

On June 10, 2009, the Judge granted preliminary approval of the settlement, and on October 5, 2009, the Judge granted final approval of the settlement. On August 26, 2010, based on the expiration of the tolling period stated in the tolling agreements with the individual officers and directors, the plaintiffs filed a Notice of Termination of Tolling Agreement and Recommencement of Litigation against the named officers and directors. The plaintiffs stated to the Court that they do not intend to take any further action against the named officers and directors at this time. Notices of appeal of the opinion granting final approval were filed by six groups of appellants. In October 2010, four of the groups of appellants withdrew their appeals with prejudice. Briefing on the remaining two appeals is ongoing.

On October 10, 2007, an Old Digimarc shareholder filed a lawsuit in the United States District Court for the Western District of Washington against several companies that acted as lead underwriters for the Old Digimarc initial public offering. The complaint, which also named Old Digimarc as a nominal defendant but did not assert any claims against Old Digimarc, asserted claims against the underwriters under Section 16(b) of the Securities Exchange Act of 1934. On February 28, 2008, an amended complaint was filed, with Old Digimarc still named only as a nominal

defendant. Similar complaints have been filed by this same plaintiff against a number of other issuers in connection with their initial public offerings, and the factual allegations are closely related to the allegations in the litigation pending in the United States District Court for the Southern District of New York which is described above.



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On March 12, 2009, after considering motions to dismiss, one filed by thirty moving issuers and the other filed by the underwriters, the judge dismissed the plaintiff's claims on a jurisdictional and statute of limitations basis. On April 10, 2009, the plaintiff filed a notice of appeal of the dismissal. The final appellate brief was filed on November 17, 2009; and oral argument was heard by the Ninth Circuit Court of Appeals on October 5, 2010. The Company currently believes that the outcome of this litigation will not have a material adverse impact on its condensed consolidated financial position and results of operations.

### *Patent Litigation*

On May 12, 2010, the Company was served with a complaint in the U.S. District Court, District of Delaware, alleging patent infringement of US Patent No. 5,913,542 regarding the making, using, offering for sale and selling of ID cards, including drivers' licenses. On August 19, 2010, the Company filed an amended answer to the complaint, which contained counterclaims for declaratory judgment against the plaintiff. Based on the preliminary nature of the proceedings, it is not possible at this stage to quantify the potential damages, exposure or liability to L-1, if any.

### *Other*

The Company records a liability for any claim, demand, litigation and other contingency when management believes that it is both probable that a liability has been incurred and can reasonably estimate the amount of the potential loss. Based on current information and belief, the Company believes it has adequate provisions for any such matters. The Company reviews these provisions quarterly and adjusts these provisions to reflect the impact of negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to a particular matter. However, because of the inherent uncertainties of litigation the ultimate outcome of certain litigation cannot be accurately predicted by the Company; it is therefore possible that the consolidated financial position, results of operations or cash flows of the Company could be materially adversely affected in any particular period by the unfavorable resolution of one or more of these matters and contingencies.

## **ITEM 1A RISK FACTORS**

This Quarterly Report on Form 10-Q contains or incorporates a number of forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements are based on current expectations, estimates, forecasts and projections about the industry and markets in which we operate and management's beliefs and assumptions. Any statements contained herein (including without limitation statements to the effect that management, we or L-1's management believes, expects, anticipates, plans and similar expressions) that are not statements of historical fact should be considered forward-looking statements and should be read in conjunction with consolidated financial statements and notes to consolidated financial statements included in this report. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. There are a number of important factors that could cause L-1's actual results to differ materially from those indicated by such forward-looking statements. These factors include, without limitation, those set forth below. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties, including those not presently known to us or that we currently deem immaterial, may also materially and adversely impact L-1's business. L-1 expressly disclaims any obligation to update any forward-looking statements, except as may be required by law.

Except as set forth below there have been no material changes from the risk factors described in L-1's Annual Report on Form 10-K for the year ended December 31, 2009. L-1 encourages you to review L-1's Annual Report on Form 10-K for a full description of the risks and uncertainties relating to our business.

### **There are risks and uncertainties associated with the proposed Safran and BAE transactions.**

There are risks and uncertainties associated with the proposed Safran and BAE transactions, including that such transactions may not be consummated, or may not be consummated as currently anticipated, as a result of several potential risks, including but not limited to: (1) with respect to the Safran merger transaction, (i) the failure to receive our shareholders' approval of the merger, (ii) the failure to consummate the BAE transaction, (iii) the inability to obtain regulatory approvals for the merger, including the expiration or termination of the applicable waiting period under the HSR Act and termination or expiration of the Committee on Foreign Review in the United States (CFIUS) review period applicable to the merger and BAE transaction or to obtain approvals without conditions that are not currently anticipated;



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or (iv) the failure to satisfy the other conditions for closing set forth in the Merger Agreement; and (2) with respect to the BAE transaction, (i) the inability to obtain regulatory approvals for the transaction, including the expiration or termination of the applicable waiting period under the HSR Act and termination or expiration of the CFIUS review period applicable to the transaction or to obtain such approvals without conditions that are not currently anticipated, or (ii) the failure to satisfy the other conditions for closing set forth in the Purchase Agreement, including the completion of certain actions in respect of organizational conflict of interest provisions under certain contracts of the Intel Business.

Under certain circumstances, if the Merger Agreement with Safran is terminated, we may be required to pay Safran a termination fee of \$25,000,000 or reimburse Safran for up to \$12,500,000 of Safran's documented out-of-pocket expenses.

Lawsuits have been filed and other lawsuits may be filed against us, Safran and BAE challenging the Safran merger and BAE transaction and seeking, among other things, injunctive relief enjoining the Safran and BAE transactions, and an adverse ruling in any such lawsuit may prevent the transactions from being completed.

The closing of the merger is conditioned on the prior consummation of the BAE transaction; however, the BAE transaction is not conditioned on the consummation of the Merger. Accordingly, if we consummate the BAE transaction but fail to subsequently consummate the merger we may be required to continue to operate the Company without the Intel Business, which could adversely affect our financial condition, results of operations and share price.

### **Our business could be adversely impacted as a result of uncertainty related to the proposed Safran and BAE transactions.**

The proposed Safran and BAE transactions (including the risks and uncertainties related to the consummation of the transactions) could cause disruptions in our business, which could have an adverse effect on our results of operations and financial condition. Our employees may experience uncertainty about their future roles at the Company, which might adversely affect our ability to retain and hire key managers and other employees. Our customers and suppliers may experience uncertainty about the Company's future and may seek alternative business relationships with third parties or seek to alter their business relationships with the Company. In addition, the attention of our management may be directed to transaction-related considerations and may be diverted from the day-to-day operations of our business. The occurrence of any of these events, individually or in combination, could adversely affect our financial condition, results of operations and share price.

The Merger Agreement and Purchase Agreement also restrict us from engaging in certain activities and taking certain actions without Safran's or BAE's approval, as applicable, which could adversely affect our ability to manage our operations effectively in light of changes in economic or market conditions or to execute our business strategy or prevent us from pursuing opportunities or other strategic alternatives that may arise prior to the closing of the transactions.

We have incurred, and will continue to incur, significant fees for professional services and other transaction costs in connection with the proposed acquisitions by Safran and BAE, and many of these fees and costs are payable by us regardless of whether we consummate either of the transactions. In addition, our stock price rose upon announcement of the proposed merger with Safran and any failure to consummate the merger could result in a drop in our stock price.

### **Covenants in the Company's credit facility may restrict financial and operating flexibility and the Company may not be able to comply with these covenants.**

L-1 is a party to a credit agreement with that provides for up to \$435.0 million in borrowings through 2013, of which \$92.0 million is currently available, subject to continuing compliance with debt covenants. Under the agreement, L-1 is required to maintain specific financial covenants related to leverage and debt service coverages. On August 30, 2010, L-1 entered into an amendment and consent (the "Third Amendment") to the Second Amended and Restated Credit Agreement dated as of August 5, 2008, among L-1 Identity Solutions Operating Company, the Company, Bank of America, N.A., the Lenders party thereto, Wachovia Bank, National Association, Banc of America Securities LLC and Wachovia Capital Markets LLC (as amended, the "Credit Agreement"). The Third Amendment extended the time period during which previously modified financial covenants will apply under the Credit Agreement due to the Company having entered into a definitive agreement providing for the sale of all or substantially all of the

assets and operations of the Company and its subsidiaries in connection with its strategic alternatives review on September 19, 2010. The Third Amendment provides that the minimum Consolidated Debt Service Coverage Ratio of 1.65 to 1.00 will remain in effect for the third fiscal quarter of 2010 and the period through and including March 30, 2011, after which the minimum Consolidated Debt Service Coverage Ratio shall return to 2.25 to 1.00 for each fiscal quarter thereafter, and the maximum Consolidated Leverage Ratio of 3.85 to 1.00 will remain in effect for the third fiscal quarter of 2010 and the period through and including March 30, 2011, after which the maximum Consolidated Leverage Ratio shall return to 2.75 to 1.00 for each fiscal quarter thereafter.

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At September 30, 2010 the Company's Consolidated Debt Service Coverage Ratio was 2.00:1.00 and the Consolidated Leverage Ratio was 3.25:1.00; accordingly the Company was in compliance with the modified financial covenants. The ability to satisfy these financial ratios in the future can be affected by events beyond the Company's control and it cannot assure meeting these ratios. If the sale of the Company's intelligence services businesses to BAE or the merger with Safran does not occur, the Company expects to refinance its debt on a long term basis or otherwise take other actions to repay or amend the term loans and other debt. There is no assurance that a refinancing or other action to repay or modify the loan can be successfully executed.

The credit agreement also places limitations on additional borrowings, mergers and related-party transactions, on payment of dividends and with respect to capital expenditures. Borrowings under the agreement are collateralized by Company's assets and bear interest at the Eurodollar Rate, or the lender's base rate, plus market-rate spreads that are determined by reference to the Company's leverage ratio.

Default under the credit facility could allow the lenders to declare all amounts outstanding to be immediately due and payable. L-1 has pledged substantially all of its assets to secure the debt under the credit facility. If the lenders declare amounts outstanding under the credit facility to be due, the lenders could proceed against those assets. Any event of default, therefore, could have a material adverse effect on the business if the creditors determine to exercise their rights. The Company also may incur future debt obligations that might subject L-1 to restrictive covenants that could affect financial and operational flexibility, restrict ability to pay dividends on common stock, or subject L-1 to other events of default.

### **L-1 has a history of operating losses.**

L-1 has a history of operating losses. The business operations began in 1993 and, except for 1996 and 2000, have resulted in losses before income taxes in each year, which have included significant asset impairments and merger related expenses, amortization of intangible assets and stock-based compensation expense. At September 30, 2010, L-1 had an accumulated deficit of approximately \$646.9 million. L-1 will continue to invest in the development of secure credential and biometric technologies and will make significant capital expenditures to meet the requirements of recently awarded secure credentialing contracts. The need for these expenditures to grow the business will affect the ability to report operating profit and reduce the accumulated deficit.

### **The Company must fund substantial capital expenditures for the secure credentialing business.**

The installation of secure credentialing systems requires significant capital expenditures. The need to fund such capital expenditures has increased following the acquisition of the secure credentialing business of Digimarc.

For the nine months ended September 30, 2010, capital expenditures increased to \$32.6 million, as compared to \$38.4 million in the corresponding period of the prior year. Capital expenditures for the year ended December 31, 2009 were approximately \$55.0 million and are expected to be in the range of \$40.0 million to \$45.0 million for the year ending December 31, 2010. While L-1 expects to fund capital requirements primarily from operating cash flows and borrowings under the revolving credit facility, in the near term, cash otherwise available to fund strategic opportunities and repay long-term debt is reduced. At September 30, 2010, L-1 had cash and cash equivalents of \$9.0 million and availability under its existing credit agreement of \$92.0 million, subject to continuing compliance with covenants contained in the agreement. While the Company believes it has adequate capital resources to meet current working capital and capital expenditure requirements and has been successful in the past in obtaining financing for acquisitions, L-1 expects to have increased capital needs as it continues to expand its business.

In addition, the ability to execute the Company's strategy may be adversely affected by the unfavorable market conditions if they persist over a prolonged period. The Company may be unsuccessful in raising additional financing to fund growth or it may have difficulty in obtaining financing at attractive rates or on terms that are not excessively dilutive to existing shareholders. Failure to secure additional financing in a timely manner and on favorable terms could have a material adverse effect on its growth, financial performance and stock price and could require the Company to delay or abandon expansion.

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**Government contracts are subject to continued appropriations by Congress and availability of funding for State and Local programs. Reduced funding or changes in procurement policies that curtail the use of outside contractors could result in terminated, delayed or de-scoped contracts with L-1 and adversely affect the ability for L-1 to meet sales and earnings goals.**

For the three and nine months ended September 30, 2010, U.S. Federal government agencies, directly or indirectly, accounted for 33 percent and 34 percent, respectively, of L-1's consolidated revenues from continuing operations. For the three and nine months ended September 30, 2009, U.S. Federal government agencies, directly or indirectly, accounted for 47 percent and 42 percent, respectively, of L-1's consolidated revenues from continuing operations. Future sales under existing and future awards of U.S. government contracts are conditioned upon the continuing availability of Congressional appropriations, which could be affected by current or future economic conditions. In addition, while spending authorizations for defense-related programs by the Federal government has increased in recent years, particularly after the 2001 terrorist attacks and more recently in support of U.S. war efforts in Southwest Asia, future levels of expenditures, mission priorities and authorizations for these programs may decrease, remain constant or shift to programs in areas where L-1 does not currently provide products or services. Current Federal government spending levels for defense-related programs are in part related to the U.S. military operations in Afghanistan and Iraq, and may not be sustainable, as a result of changes in government leadership, policies or priorities.

Similar to Federal government contracts, State and Local government agency contracts may be contingent upon availability of funds provided by Federal, State or Local entities. In the current economic environment, many States may reduce expenditures which may result in cancellation or deferral of projects. State and Local law enforcement and other government agencies are subject to political, budgetary, purchasing and delivery constraints which may result in quarterly and annual revenue and operating results that may be irregular and difficult to predict. Such revenue volatility makes management of inventory levels, cash flows and profitability inherently difficult. In addition, if L-1 is successful in winning such procurements, there may be unevenness in delivery schedules, as well as potential delays and changes in the timing of deliveries and recognition of revenue, or cancellation of such procurements.

**The L-1 plan to pursue sales in international markets may be limited by risks related to conditions in such markets.**

For the three and nine months ended September 30, 2010, L-1 derived approximately 11 percent and 13 percent, respectively, of total revenues from international sales of continuing operations and the Company's strategy is to expand its international operations. There is a risk that the Company may not be able to successfully market, sell and deliver solutions, products and services in foreign countries.

Risks inherent in marketing, selling and delivering products in foreign and international markets, each of which could have a severe negative impact on financial results and stock price, include those associated with:

- regional economic or political conditions.

- delays in or absolute prohibitions on exporting solutions, products and services resulting from export restrictions for certain products and technologies.

- loss of, or delays in importing products, services and intellectual property developed abroad, resulting from unstable or fluctuating social, political or governmental conditions.

- fluctuations in foreign currencies related to the U.S. dollar.

- loss of revenue, property (including intellectual property) and equipment from expropriation, nationalization, war, insurrection, terrorism, criminal acts and other political and social risks.

- liabilities resulting from any unauthorized actions of local resellers or agents under the Foreign Corrupt Practices Act or local anti-corruption statutes.

overlap of different tax structures.

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risks of increases in taxes and other government fees.

involuntary renegotiations of contracts with foreign governments.

L-1 expects that it will have increased exposure to foreign currency fluctuations. As of September 30, 2010, accumulated other comprehensive income includes foreign currency translation gains of approximately \$0.7 million.

In addition, L-1 has significant Japanese Yen denominated transactions with Japanese suppliers of hardware and consumables for the delivery to customers. Fluctuations in foreign currencies, including the Japanese Yen as well as Canadian Dollar, and the Euro could result in unexpected fluctuations to results of operations, which could be material and adverse.

**ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

None.

**ITEM 3 DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4 [REMOVED AND RESERVED]**

**ITEM 5 OTHER INFORMATION**

On February 3, 2010, the Company announced that it will be the exclusive provider for the program formerly known as Registered Traveler as a result of Alclear LLC winning the competitive bid for Verified Identity Pass Inc. assets in a bankruptcy auction proceeding. In connection with the transaction, the Company expected to receive a minority equity interest in Alclear in exchange for prior investments and contributions to the program. Mr. LaPenta was also expected to receive a minority equity interest in Alclear through a proposed personal cash investment in Alclear. It was expected that Alclear and L-1 would enter into a multi-year contract pursuant to which the Company would serve as prime integrator. Alclear and L-1 have not successfully negotiated mutually agreeable terms for the L-1 investment or a prime integrator relationship at this time. Accordingly, L-1 and Mr. LaPenta do not currently intend to invest in Alclear and the Company does not expect that it will be the exclusive provider for the Registered Traveler program or that it will receive a minority interest in Alclear. L-1 and Alclear may enter into future commercial arrangements on mutually acceptable terms, but there can be no assurance that any such arrangements will be made.

**ITEM 6 EXHIBITS**

The exhibits listed in the Exhibits Index immediately preceding such exhibits are filed as part of this report.



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**L-1 IDENTITY SOLUTIONS, INC.  
SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: November 3, 2010

By: /s/ ROBERT V. LAPENTA

**Robert V. LaPenta  
Chairman of the Board,  
Chief Executive Officer and President  
(Principal Executive Officer)**

Date: November 3, 2010

By: /s/ JAMES A. DEPALMA

**James A. DePalma  
Executive Vice President,  
Chief Financial Officer and Treasurer  
(Principal Financial Officer)**

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**EXHIBIT INDEX**

**Exhibit**

| <b>No.</b> | <b>Description</b>   |
|------------|--|
| 31.1       | Certification of Principal Executive Officer pursuant to Rules 13a-14(a) under the Securities Exchange Act of 1934, as amended (filed herewith).                     |
| 31.2       | Certification of Principal Financial Officer pursuant to Rules 13a-14(a) under the Securities Exchange Act of 1934, as amended (filed herewith).                     |
| 32.1       | Certification of Principal Executive Officer pursuant to 18 U.S.C. Sec. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith). |
| 32.2       | Certification of Principal Financial Officer pursuant to 18 U.S.C. Sec. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith). |