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PATRON SYSTEMS INC
Form 10QSB/A
May 21, 2007

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

FORM 10-QSB/A
(Amendment No. 1)

(Mark One)
 QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE
ACT OF 1934

For the quarterly period ended March 31, 2006

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT

For the transition period from _____ to _____

COMMISSION FILE NUMBER 0-25675

PATRON SYSTEMS, INC.
(EXACT NAME OF SMALL BUSINESS ISSUER AS SPECIFIED IN ITS CHARTER)

DELAWARE
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)

74-3055158
(IRS EMPLOYER IDENTIFICATION NO.)

5775 FLATIRON PARKWAY, SUITE 230
BOULDER, CO
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)

80301
(ZIP CODE)

(303) 541-1005
(ISSUER'S TELEPHONE NUMBER)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: 1,879,946 shares of common stock outstanding as of May 11, 2006.

Transitional Small Business Disclosure Format (Check one): Yes No

PATRON SYSTEMS, INC.

FORM 10-QSB/A QUARTERLY REPORT

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EXPLANATORY NOTE

Patron Systems, Inc. is filing this Amendment No. 1 to its Quarterly Report on Form 10-QSB (the "Form 10-QSB") for the quarterly period ended March 31, 2006 filed with the Securities and Exchange Commission on May 22, 2006. This filing amends and restates our previously reported financial statements for the three months ended March 31, 2006 to reflect the determination by the Company that it had recorded 1) a net loss of \$858,213 on the settlement of various liabilities under its creditor and claimant liabilities restructuring program when it should have recorded a net gain of approximately \$906,987, 2) excess non-cash interest of \$358,000 with respect to a conversion option that became effective under two of its Interim Bridge Financing III notes and 3) charged, as interest expense, a \$285,050 fee paid to the placement agent in its Series A Preferred stock financing transaction that should have been recorded as a reduction of the offering proceeds. The nature of the adjustments required in the creditor and claimant liabilities restructuring relate to an overvaluation of the Series A-1 preferred shares issued in the exchange offer offset by gains on the extinguishment of liabilities that originated in connection with obligations to issue or repurchase stock.

This Amendment No. 1 amends and restates the following items of our Form 10-QSB as described above: (i) Part I, Item 1 - Financial Statements; (ii) Part I, Item 2 - Management's Discussion and Analysis of Result of Operations and Financial Condition; and (iii) Part II, Item 6 - Exhibits. This amendment includes in the calculation of earnings per share the effect of the 1-for-30 reverse stock split that was effective July 31, 2006.

All information in our Form 10-QSB, as amended by this Amendment No. 1, speaks

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as to the date of the original filing of our Form 10-QSB for such period and does not reflect any subsequent information or events except as noted in this Amendment No. 1. All information contained in this Amendment No. 1 is subject to updating and supplementing as provided in our reports, as amended, filed with the Securities and Exchange Commission subsequent to the date of the initial filing of our Form 10-QSB.

FORWARD LOOKING STATEMENTS

The following discussion and explanations should be read in conjunction with the financial statements and related notes contained elsewhere in this Form 10-QSB/A. Certain statements made in this discussion are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements can be identified by terminology such as "may", "will", "should", "expects", "intends", "anticipates", "believes", "estimates", "predicts", or "continue" or the negative of these terms or other comparable terminology. Because forward-looking statements involve risks and uncertainties, there are important factors that could cause actual results to differ materially from those expressed or implied by these forward-looking statements. Although Patron Systems believes that expectations reflected in the forward-looking statements are reasonable, it cannot guarantee future results, performance or achievements. Moreover, neither Patron Systems nor any other person assumes responsibility for the accuracy and completeness of these forward-looking statements. Patron Systems is under no duty to update any forward-looking statements after the date of this report to conform such statements to actual results.

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PART I - FINANCIAL INFORMATION

ITEM 1 FINANCIAL STATEMENTS

PATRON SYSTEMS, INC. AND SUBSIDIARIES CONDENSED CONSOLIDATED BALANCE SHEET (Unaudited)

| | MARCH 31, 2006 (AS RESTATED) |
|--|------------------------------------|
| ----- | |
| ASSETS | |
| Current Assets | |
| Cash and cash equivalents | \$ 141,430 |
| Restricted cash | 1,468,813 |
| Accounts receivable, net | 55,545 |
| Other current assets | 135,059 |
| | ----- |
| Total current assets | 1,800,847 |
| Property and equipment, net | 101,544 |
| Intangible assets, net | 1,385,717 |
| Unbilled accounts receivable | 54,654 |
| Net assets of discontinued operation | 94,277 |
| Goodwill | 9,510,716 |
| | ----- |
| Total assets | \$ 12,947,755 |
| | ===== |

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LIABILITIES AND STOCKHOLDERS' EQUITY

Current Liabilities

| | |
|--|--------------|
| Accounts payable | \$ 1,239,813 |
| Accrued payroll and related expenses | 447,253 |
| Accrued interest | 744,679 |
| Notes payable (to creditors of acquired business); including \$1,538,129 to related parties | 1,790,911 |
| Demand notes payable | 471,056 |
| Expense reimbursements due to officers and stockholders | 166,183 |
| Accrued registration penalty | 84,780 |
| Deferred revenue | 190,009 |
| Notes payable to officers and stockholders | 235,712 |
| Other current liabilities | 515,173 |
| Bridge notes payable | 1,544,975 |
| Net liabilities of discontinued operations | 30,201 |
| | ----- |
| Total current liabilities | 7,460,745 |
| | ----- |

Commitments and Contingencies

Stockholders' Equity

| | |
|--|---------------|
| Preferred stock, par value \$0.01 per share, 75,000,000 shares authorized, - Series A Convertible: 2,160 shares authorized; 893 shares issued and outstanding | 9 |
| liquidation preference of \$6,030,909 | |
| - Series A-1 convertible: 50,000,000 authorized; 33,420,078 issued and outstanding | 334,201 |
| liquidation preference of \$26,736,063 | |
| Common stock, par value \$0.01 per share, 150,000,000 shares authorized, 1,879,946 shares issued and outstanding | 18,800 |
| Additional paid-in capital | 91,513,851 |
| Accumulated deficit | (86,379,851) |
| | ----- |
| Total stockholders' equity | 5,487,010 |
| | ----- |
| Total liabilities and stockholders' equity | \$ 12,947,755 |
| | ===== |

See notes to condensed consolidated financial statements.

PATRON SYSTEMS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

| | THREE MONTHS ENDED MARCH 31, | |
|---------------|------------------------------|----------|
| | 2006 | 2005 |
| | (AS RESTATED) | |
| | ----- | ----- |
| Revenue | \$ 261,785 | \$ 6,430 |
| | ----- | ----- |
| Cost of Sales | | |

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| | | |
|---|----------------|----------------|
| Cost of products/services | 29,897 | 2,003 |
| Amortization of technology | 27,522 | 19,230 |
| | ----- | ----- |
| Total cost of sales | 57,419 | 21,233 |
| | ----- | ----- |
| Gross profit | 204,366 | (14,803) |
| | ----- | ----- |
| Operating Expenses | | |
| Salaries and related expenses | 1,010,123 | 370,349 |
| Professional fees | 658,115 | 141,401 |
| General and administrative (includes non-employee stock-based compensation of \$0 and \$508,500 for the three months ended March 31, 2006 and 2005, respectively) | 323,909 | 722,064 |
| Amortization of intangibles | 30,814 | 8,063 |
| Stock based penalties under financing arrangements | 2,852 | 369,000 |
| Settlement gain | (906,987) | -- |
| | ----- | ----- |
| Total operating expenses | 1,118,826 | 1,610,877 |
| | ----- | ----- |
| Loss from operations | (914,460) | (1,625,680) |
| | ----- | ----- |
| Other Income (Expense) | | |
| Interest income | -- | 19,250 |
| Interest expense | (972,464) | (494,988) |
| Gain on sale of property and equipment | 62 | -- |
| | ----- | ----- |
| Total Other Expense | (972,402) | (475,738) |
| | ----- | ----- |
| Loss from continuing operations before income taxes | (1,886,862) | (2,101,418) |
| | ----- | ----- |
| Income taxes | -- | -- |
| | ----- | ----- |
| Loss from continuing operations | (1,886,862) | (2,101,418) |
| | ----- | ----- |
| Loss from discontinued operations | (104,962) | (102,377) |
| | ----- | ----- |
| Net loss | \$ (1,991,824) | \$ (2,203,795) |
| | ===== | ===== |
| Net Loss Per Share - Basic and Diluted | | |
| - Continuing operations | \$ (0.91) | \$ (1.24) |
| - Discontinued operations | (0.05) | (0.06) |
| | ----- | ----- |
| - Total | \$ (0.96) | \$ (1.30) |
| | ===== | ===== |
| Weighted Average Number of Common Shares | | |
| Outstanding | | |
| - Basic and Diluted | 2,083,954 | 1,689,558 |
| | ===== | ===== |

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See notes to condensed consolidated financial statements.

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PATRON SYSTEMS, INC. AND SUBSIDIARIES
 CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' (DEFICIENCY) EQUITY
 FOR THE THREE MONTHS ENDED MARCH 31, 2006
 (Unaudited)

| | SHARES OF SERIES A PREFERRED STOCK | PAR VALUE SERIES A PREFERRED STOCK | SHARES OF SERIES A-1 PREFERRED STOCK | PAR VALUE SERIES A-1 PREFERRED STOCK | SHARES OF COMMON STOCK (AS RESTATED) |
|---|---|---|---|---|--|
| BALANCE, JANUARY 1, 2006 | -- | \$ -- | -- | \$ -- | 1 |
| Amortization of deferred stock-based compensation ... | -- | -- | -- | -- | -- |
| Issuance of Series A Preferred Stock to investors | 893 | 9 | -- | -- | -- |
| Issuance of warrants in connection with bridge loan extension - extension warrants | -- | -- | -- | -- | -- |
| Conversion option penalty incurred upon default of Bridge Financing III | -- | -- | -- | -- | -- |
| Cancellation of Stock Repurchase obligation due to former officer | -- | -- | -- | -- | -- |
| Issuance of Series A-1 Preferred stock in settlement of debt | -- | -- | 33,420,078 | 334,201 | -- |
| Vested portion of stock options | -- | -- | -- | -- | -- |
| Net Loss | -- | -- | -- | -- | -- |
| BALANCE MARCH 31, 2006 (AS RESTATED) | 893 | \$ 9 | 33,420,078 | \$ 334,201 | 1 |

| | ADDITIONAL PAID IN CAPITAL (AS RESTATED) | COMMON STOCK REPURCHASE OBLIGATION | DEFERRED COMPENSATION | ACCUMULATED DEFICIT (AS RESTATED) | SHARES OF COMMON STOCK (AS RESTATED) |
|--|---|---|--------------------------|---|--|
| BALANCE, JANUARY 1, 2006 | \$ 65,601,276 | \$ (1,300,000) | \$ (7,500) | \$ (84,388,027) | 1 |
| Amortization of deferred stock-based compensation ... | -- | -- | 7,500 | -- | -- |
| Issuance of Series A Preferred Stock to investors | 4,180,441 | -- | -- | -- | -- |

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| | | | | |
|--|---------------|-----------|-------|-----------------|
| Issuance of warrants in connection with bridge loan extension - extension warrants | 48,129 | -- | -- | -- |
| Conversion option penalty incurred upon default of Bridge Financing III | 192,000 | -- | -- | -- |
| Cancellation of Stock Repurchase obligation due to former officer | 1,300,000 | 1,300,000 | -- | -- |
| Issuance of Series A-1 Preferred stock in settlement of debt | 20,018,670 | -- | -- | -- |
| Vested portion of stock options | 173,335 | -- | -- | -- |
| Net Loss | -- | -- | -- | (1,991,824) |
| | ----- | ----- | ----- | ----- |
| BALANCE MARCH 31, 2006 (AS RESTATED) | \$ 91,513,851 | \$ -- | \$ -- | \$ (86,379,851) |
| | ===== | ===== | ===== | ===== |

See notes to condensed consolidated financial statements.

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PATRON SYSTEMS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

| | THREE MONTHS ENDED MARCH 31, | |
|---|------------------------------|----------------|
| | 2006 | 2005 |
| | (AS RESTATED) | |
| | ----- | ----- |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net loss | \$ (1,991,824) | \$ (2,203,795) |
| | ===== | ===== |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization | 70,796 | 19,525 |
| Accretion related to warrants issued for notes payable | 20,909 | 260,965 |
| Amortization of deferred financing costs | 282,129 | 153,520 |
| Stock based penalty under financing arrangements | 2,852 | 369,000 |
| Non-cash interest income | -- | (19,250) |
| Non-cash increase in interest payable to former stockholder . | 48,400 | -- |
| Conversion option in connection with bridge note holders | 192,000 | -- |
| Stock based compensation | 180,835 | 508,500 |
| Gain on issuance of preferred stock in settlement of debt ... | (906,987) | -- |
| Changes in assets and liabilities: | | |
| Restricted cash escrowed to settle liabilities assumed | (957,122) | (1,388,000) |
| Prepaid expenses | -- | 10,637 |
| Accounts receivable | 113,945 | (58,518) |
| Other current assets | 17,809 | 110,533 |
| Accounts payable | (268,700) | (325,017) |
| Accrued interest | 429,027 | 94,827 |

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| | | |
|---|--------------|-------------|
| Deferred revenue | (142,072) | 35,283 |
| Expense reimbursements due to officers and shareholders ... | (7,354) | (94,500) |
| Accrued payroll and payroll related expenses | (311,041) | (72,250) |
| Loss on sale of fixed assets | (62) | -- |
| Other current liabilities | (197,271) | 31,439 |
| Other accrued expenses | -- | (3,413) |
| | ===== | ===== |
| Total adjustments | (1,431,907) | (366,719) |
| | ===== | ===== |
| NET CASH USED IN OPERATIONS - CONTINUING OPERATIONS | (3,423,731) | (2,570,514) |
| | ===== | ===== |
| NET CASH USED IN OPERATIONS - DISCONTINUED OPERATIONS | (31,076) | -- |
| | ----- | ----- |
| NET CASH USED IN OPERATING ACTIVITIES | (3,454,807) | (2,570,514) |
| | ----- | ----- |
| CASH FLOWS USED IN INVESTING ACTIVITIES | | |
| Cash payments in purchase business combinations | -- | (857,633) |
| Cash acquired in purchase business combinations | -- | 416,397 |
| Purchase and development of technology | (211,294) | -- |
| Proceeds from sale of fixed assets | 1,755 | -- |
| Purchase of fixed assets | (12,689) | (32,055) |
| | ----- | ----- |
| NET CASH USED IN INVESTING ACTIVITIES - CONTINUING OPERATIONS ... | (222,228) | (473,291) |
| | ===== | ===== |
| NET CASH USED IN INVESTING ACTIVITIES - DISCONTINUED OPERATIONS . | (3,000) | -- |
| | ----- | ----- |
| NET CASH USED IN INVESTING ACTIVITIES | (225,228) | (473,291) |
| | ----- | ----- |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Expenses financed by (repaid to) officers and stockholders | -- | (225,000) |
| Payments on settlement of accommodation agreements | (125,000) | -- |
| Advances from stockholders | -- | 500,000 |
| Deferred financing costs | (54,000) | (316,579) |
| Proceeds from issuance of preferred series A stock | 4,000,451 | -- |
| Proceeds from issuance of bridge notes | -- | 3,500,000 |
| Repayments of advances from shareholders | -- | (93,796) |
| | ----- | ----- |
| NET CASH PROVIDED BY FINANCING ACTIVITIES - CONTINUING OPERATIONS | 3,821,451 | 3,364,625 |
| | ===== | ===== |
| NET INCREASE IN CASH AND CASH EQUIVALENTS | \$ 141,416 | \$ 320,820 |
| CASH AND CASH EQUIVALENTS, beginning of period | \$ 14 | \$ 45,901 |
| | ----- | ----- |
| CASH AND CASH EQUIVALENTS, end of period | \$ 141,430 | \$ 366,721 |
| | ===== | ===== |
| Supplemental Disclosures of Cash Flow Information: | | |
| Cash paid during the period for: | | |
| Interest | \$ 476 | \$ 214,428 |
| Liabilities and claims settled in exchange for Series A-1 | | |
| Preferred Stock | \$21,258,875 | |

See notes to condensed consolidated financial statements.

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PATRON SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
MARCH 31, 2006

NOTE 1 - BASIS OF INTERIM FINANCIAL STATEMENT PRESENTATION

The accompanying unaudited Condensed Consolidated Financial Statements of Patron Systems, Inc. and subsidiaries (the "Company," "Patron," "us," or "we") have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and the instructions to Form 10-QSB. Accordingly, they do not include all the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the financial position, results of operations and cash flows for all periods presented have been made. The results of operations for the three-month period ended March 31, 2006 are not necessarily indicative of the operating results that may be expected for the entire year ending December 31, 2006.

On July 31, 2006, the Company effectuated a 1-for-30 reverse stock split of its common stock following the effectiveness of the amendment to its Second Amended and Restated Certificate of Incorporation which was approved by stockholders at the 2006 Annual Meeting of Stockholders on July 20, 2006. The accompanying financial statements give retroactive effect to the reverse split for all periods presented.

This Form 10-QSB/A should be read in conjunction with the Company's 10-KSB for the year ended December 31, 2005.

NOTE 2 - THE COMPANY

ORGANIZATION AND DESCRIPTION OF BUSINESS

Patron Systems, Inc., ("Systems") is a Delaware corporation formed in April 2002 to provide comprehensive, end-to-end information security solutions to global corporations and government institutions.

Pursuant to an Amended and Restated Share Exchange Agreement dated October 11, 2002, Combined Professional Services ("CPS"), Systems and the stockholders of Systems consummated a share exchange ("Share Exchange"). As a result of the Share Exchange, the former stockholders of Systems became the majority stockholders of CPS. Accordingly, Systems became the accounting acquirer of CPS and the exchange was accounted for as a reverse merger and recapitalization of Systems. CPS subsequently merged with Systems, with Systems surviving the merger. The combined entity continued to use the name Patron Systems, Inc.

NOTE 3 - RESTATEMENT OF PREVIOUSLY ISSUED FINANCIAL STATEMENTS

The Company, while undergoing the audit of its consolidated financial statements for the year ended December 31, 2006, became aware of possible misstatements in its unaudited condensed consolidated interim financial statements filed with the Securities and Exchange Commission during the year ended December 31, 2006. On March 6, 2007, the Company's Board of Directors determined that certain amounts reported in its unaudited condensed consolidated interim financial statements for the quarters ended March 31, 2006, and June 30, 2006, and for the six months ended June 30, 2006 and nine months ended September 30, 2006 needed to be restated as described below.

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The specific errors that came to management's attention relate to the Company's accounting for certain transactions that occurred during the quarter ended March 31, 2006 and the quarter ended June 30, 2006. Upon review of these transactions, Company management discovered that the accounting for these transactions resulted in a \$2,408,250 overstatement of its loss for the quarterly period ended March 31, 2006 and a \$593,765 overstatement of its loss for the quarterly period ended June 30, 2006, which also resulted in an overstatement of the year to date losses in the six and nine month periods ended June 30, 2006 and September 30, 2006, respectively.

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Specifically, the Company recorded for the three months ended March 31, 2006, (1) a net loss of \$858,213 on the settlement of various liabilities under its creditor and claimant liabilities restructuring program when it should have recorded a net gain of approximately \$906,987, (2) recorded excess non-cash interest of \$358,000 with respect to a conversion option that became effective under two of its Interim Bridge Financing III notes and (3) charged, as interest expense, a \$285,050 fee paid to the placement agent in its Series A Preferred stock financing transaction that should have been recorded as a reduction of the offering proceeds. The nature of the adjustments required in the creditor and claimant liabilities restructuring relate to an overvaluation of the Series A-1 preferred shares issued in the exchange offer offset by gains on the extinguishment of liabilities that originated in connection with obligations to issue or repurchase stock.

The effect of the restatement on the Company's previously issued unaudited condensed consolidated interim financial statements is as follows:

| | Three Months ended March 31, 2006 | |
|---|---|-----------------|
| | As Previously Reported | As Restated |
| Loss/(Gain) associated with settlement agreements | \$ 858,213 | \$ (906,987) |
| Interest expense | \$ (1,615,514) | \$ (972,464) |
| Net loss from continuing operations | \$ (4,295,112) | \$ (1,886,862) |
| Net loss available to common stockholders .. | \$ (4,400,074) | \$ (1,991,824) |
| Net loss per share-continuing operations ... | \$ (2.06) | \$ (0.91) |
| Net loss per share - total | \$ (2.11) | \$ (0.96) |
| Additional paid in capital | \$ 93,922,101 | \$ 91,513,851 |
| Accumulated Deficit | \$ (88,788,101) | \$ (86,379,851) |

A) For the quarter ended March 31, 2006, the effect was to reduce the net loss, accumulated deficit and additional paid in capital by \$2,408,250 and net loss per share by \$1.15 per share.

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NOTE 4 - LIQUIDITY AND FINANCIAL CONDITION

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. The Company incurred a net loss of \$1,991,824 for the three months ended March 31, 2006, which includes an aggregate of \$109,066 of net non-cash gains including the conversion option cost for bridge note and subordinated note holders, non-cash interest expense, and stock based compensation. The Company used net cash in its operating activities of \$3,454,807 during the three months ended March 31, 2006. The Company's working capital deficiency at March 31, 2006 amounted to \$5,659,898 and the Company is continuing to experience

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shortages in working capital. The Company is also involved in litigation and is being investigated by the Securities and Exchange Commission with respect to certain of its press releases and its use of form S-8 to register shares of common stock issued to certain consultants (Note 16). The Company cannot provide any assurance that the outcome of these matters will not have a material adverse affect on its ability to sustain the business. These matters raise substantial doubt about the Company's ability to continue as a going concern. The accompanying financial statements do not include any adjustments that may result from the outcome of this uncertainty.

The Company expects to continue incurring losses for the foreseeable future due to the inherent uncertainty that is related to establishing the commercial feasibility of technological products and developing a presence in new markets. The Company's ability to successfully market its software products, grow revenue and generate cash flows of certain businesses it acquired in 2005 is critical to the realization of its business plan. The Company raised \$4,285,501 of gross proceeds (\$3,946,451 net proceeds after the payment of certain transaction expenses) in financing transactions during the three months ended March 31, 2006. The Company used \$3,454,807 of these proceeds to fund its operations and a net of \$225,228 in investing activities. On January 12, 2006, the Company offered its creditors and claimants an agreement to receive Series A-1 Convertible Preferred Stock, par value \$0.01 per share ("Series A-1 Preferred") for amounts owed to the holders of the Company's indebtedness (including lenders, past-due trade accounts, and employees, consultants and other service providers with claims for fees, wages or expenses) (Note 17). As of March 31, 2006, Creditors representing approximately \$21.4 million of the Company's outstanding debts, claims and other liabilities accepted this proposal by signing and returning to the Company the Stock Subscription Agreement and Mutual Release. The Company is currently unable to determine whether all of its remaining creditors will accept its proposal or that the acceptance of such proposal will actually improve the Company's ability to fund the further development of its business plan or improve its operations.

The Company is currently in the process of attempting to raise additional capital and has taken certain steps to conserve its liquidity while it continues to integrate the businesses acquired in 2005. Although management believes that the Company has access to capital resources, the Company has not secured any commitments for additional financing at this time nor can the Company provide any assurance that it will be successful in its efforts to raise additional capital and/or successfully execute its business plan.

NOTE 5 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

PRINCIPLES OF CONSOLIDATION

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The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Entelagent Software Corporation, Complete Security Solutions, Inc., LucidLine, Inc. and PILEC Disbursement Company. All significant inter-company transactions have been eliminated.

CASH

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

REVENUE RECOGNITION

The Company derives revenues from the following sources: (1) sales of computer software, which includes new software licenses and software updates and product support revenues and (2) services, which include internet access, back-up, retrieval and restoration services and professional consulting services.

The Company applies the revenue recognition principles set forth under AICPA Statement of Position ("SOP") 97-2 "Software Revenue Recognition" and Securities and Exchange Commission Staff Accounting Bulletin ("SAB") 104 "Revenue Recognition" with respect to its revenue. Accordingly, the Company records revenue when (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred, (iii) the vendor's fee is fixed or determinable, and (iv) collectability is reasonably assured.

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The Company generates revenues through sales of software licenses and annual support subscription agreements, which include access to technical support and software updates (if and when available). Software license revenues are generated from licensing the rights to use products directly to end-users and through third party service providers.

Revenues from software license agreements are generally recognized upon delivery of software to the customer. All of the Company's software sales are supported by a written contract or other evidence of sale transaction such as a customer purchase order. These forms of evidence clearly indicate the selling price to the customer, shipping terms, payment terms (generally 30 days) and refund policy, if any. The selling prices of these products are fixed at the time the sale is consummated.

Revenue from post contract customer support arrangements or undelivered elements are deferred and recognized at the time of delivery or over the period in which the services are performed based on vendor specific objective evidence of fair value for such undelivered elements. Vendor specific objective evidence is typically based on the price charged when an element is sold separately or, if an element is not sold separately, on the price established by an authorized level of management, if it is probable that the price, once established, will not change before market introduction. The Company uses the residual method prescribed in SOP 98-9, "Modification of SOP 97-2, Software Revenue Recognition With Respect to Certain Transaction" to allocate revenues to delivered elements once it has established vendor-specific objective evidence of fair value for such undelivered elements.

The Company provides its internet access and back-up, retrieval and restoration services under contractual arrangements with terms ranging from 1 year to 5 years. These contracts are billed monthly, in advance, based on the contractually stated rates. At the inception of a contract, the Company may

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activate the customer's account for a contractual fee that it amortizes over the term of the contract in accordance with Emerging Issues Task Force Issue ("EITF") 00-21, "Revenue Arrangements with Multiple Deliverables." The Company's standard contracts are automatically renewable by the customer unless terminated on 30 days written notice. Early termination of the contract generally results in an early termination fee equal to the lesser of six months of service or the remaining term of the contract.

Professional consulting services are billed based on the number of hours of consultant services provided and the hourly billing rates. The Company recognizes revenue under these arrangements as the service is performed.

BUSINESS COMBINATIONS

In accordance with business combination accounting, we allocate the purchase price of acquired companies to the tangible and intangible assets acquired, liabilities assumed, as well as in-process research and development based on their estimated fair values. We engaged a third-party appraisal firm to assist management in determining the fair values of certain assets acquired and liabilities assumed. Such a valuation requires management to make significant estimates and assumptions, especially with respect to intangible assets.

Management makes estimates of fair value based upon assumptions believed to be reasonable. These estimates are based on historical experience and information obtained from the management of the acquired companies. Critical estimates in valuing certain of the intangible assets include but are not limited to: future expected cash flows from license sales, maintenance agreements, customer contracts and acquired developed technologies; expected costs to develop the in-process research and development into commercially viable products; the acquired company's brand awareness and market position, as well as assumptions about the period of time the acquired brand will continue to be used in the combined company's product portfolio; and discount rates. These estimates are inherently uncertain and unpredictable. Assumptions may be incomplete or inaccurate, and unanticipated events and circumstances may occur which may affect the accuracy or validity of such assumptions, estimates or actual results.

ACCOUNTS RECEIVABLE

The Company adjusts its accounts receivable balances that it deems to be uncollectible. The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses in the Company's existing accounts receivable. The Company reviews its allowance for doubtful accounts on a monthly basis and determines the allowance based on an analysis of its past due accounts. All past due balances that are over 90 days are reviewed individually for collectability. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote.

PROPERTY AND EQUIPMENT

Property and equipment is stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets (generally three to five years). Maintenance and repairs are charged to expense as incurred; cost of major additions and betterments are capitalized. When property and equipment is sold or otherwise disposed of, the cost and related accumulated depreciation are eliminated from the accounts and any resulting gains or losses

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are reflected in the statement of operations in the period of disposal.

GOODWILL AND INTANGIBLE ASSETS

We account for Goodwill and Intangible Assets in accordance with Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets." Under SFAS No. 142, goodwill and intangibles that are deemed to have indefinite lives are no longer amortized but, instead, are to be reviewed at least annually for impairment. Application of the goodwill impairment test requires judgment, including the identification of reporting units, assigning assets and liabilities to reporting units, assigning goodwill to reporting units, and determining the fair value. Significant judgments required to estimate the fair value of reporting units include estimating future cash flows, determining appropriate discount rates and other assumptions. Changes in these estimates and assumptions could materially affect the determination of fair value and/or goodwill impairment for each reporting unit. The Company recorded goodwill in connection with the Company's acquisitions described in Note 6 amounting to \$22,440,412. The Company's annual impairment review of goodwill resulted in goodwill impairment charges totaling \$12,929,696 for the year ended December 31, 2005 (Note 6) resulting in \$9,510,716 in goodwill at March 31, 2006.

LONG LIVED ASSETS

The Company periodically reviews the carrying values of its long lived assets in accordance with SFAS 144, "Long Lived Assets" when events or changes in circumstances would indicate that it is more likely than not that their carrying values may exceed their realizable value and records impairment charges when necessary. The Company's review of the carrying values of its long lived assets, which principally consist of amortizable intangibles from acquired businesses, resulted in an impairment charge of \$1,705,455 for the year ended December 31, 2005 (Note 9). Amortizable intangible assets continue to be amortized over their estimated useful lives. The Company evaluated the carrying amounts of its goodwill and intangible assets as of March 31, 2006 and determined that impairment charges are not necessary.

USE OF ESTIMATES IN PREPARING FINANCIAL STATEMENTS

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and revenue and expenses during the reporting period. The Company's significant estimates principally include the valuation of its intangible assets and goodwill and accrued liability for the Company's estimate of the fair value of preferred stock issued upon the settlement of the creditor and claimant liabilities restructuring in March 2006 (Note 17). Actual results could differ from those estimates.

FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amounts reported in the balance sheet for cash, accounts receivable, accounts payable accrued expenses, advances from stockholders and all note obligations classified as current liabilities approximate their fair values based on the short-term maturity of these instruments. The carrying amounts of the Company's convertible and subordinated note obligations, stock repurchase obligation and common stock subject to put right approximate fair value as such instruments feature contractual interest rates that are consistent with current market rates of interest or have effective yields that are consistent with instruments of similar risk, when taken together with any equity instruments concurrently issued to holders.

PREFERRED STOCK

The Company applies the guidance enumerated in SFAS No. 150 "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity" and EITF Topic D-98 "Classification and Measurement of Redeemable Securities," when determining the classification and measurement of preferred stock. Preferred shares subject to mandatory redemption (if any) are classified as liability instruments and are measured at fair value in accordance with SFAS 150. All other issuances of preferred stock are subject to the classification and measurement principles of EITF Topic D-98. Accordingly the Company classifies conditionally redeemable preferred shares (if any), which includes preferred shares that feature redemption rights that are either within the control of the holder or subject to redemption upon the occurrence of uncertain events not solely within the Company's control, as temporary equity. At all other times, the Company classifies its preferred shares in stockholders' equity.

The Company's preferred shares do not feature any redemption rights within the holders control or conditional redemption features not within the Company's control as of March 31, 2006. Accordingly all issuances of preferred stock are presented as a component of stockholders equity.

CONVERTIBLE INSTRUMENTS

The Company evaluates and accounts for conversion options embedded in its convertible instruments in accordance with SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133") and EITF 00-19 "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock" ("EITF 00-19").

SFAS 133 generally provides three criteria that, if met, require companies to bifurcate conversion options from their host instruments and account for them as free standing derivative financial instruments in accordance with EITF 00-19. These three criteria include circumstances in which (a) the economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract, (b) the hybrid instrument that embodies both the embedded derivative instrument and the host contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur and (c) a separate instrument with the same terms as the embedded derivative instrument would be considered a derivative instrument subject to the requirements of SFAS 133. SFAS 133 and EITF 00-19 also provide an exception to this rule when the host instrument is deemed to be conventional (as that term is described in the implementation guidance to SFAS 133 and further clarified in EITF 05-2 "The Meaning of "Conventional Convertible Debt Instrument" in Issue No. 00-19).

The Company accounts for convertible instruments (when it has determined that the embedded conversion options should not be bifurcated from their host instruments) in accordance with the provisions of EITF 98-5 "Accounting for Convertible Securities with Beneficial Conversion Features," ("EITF 98-5") and EITF 00-27 "Application of EITF 98-5 to Certain Convertible Instruments." Accordingly, the Company records when necessary discounts to convertible notes for the intrinsic value of conversion options embedded in debt instruments based upon the differences between the fair value of the underlying common stock at the commitment date of the note transaction and the effective conversion price

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embedded in the note. Debt discounts under these arrangements are amortized over the term of the related debt to their earliest date of redemption. The Company also records when necessary deemed dividends for the intrinsic value of conversion options embedded in preferred shares based upon the differences between the fair value of the underlying common stock at the commitment date of the note transaction and the effective conversion price embedded in the note.

The Company evaluated the conversion option embedded in its convertible instruments during each of the reporting periods presented and has determined, in accordance with the provisions of these statements, that it does not meet the criteria requiring bifurcation of these instruments.

The Company determined that the conversion option embedded in its Series A Convertible Preferred Stock, par value \$0.01 per share ("Series A Preferred"), is not a free standing derivative in accordance with the implementation guidance provided in paragraph 61 (1) of Appendix A to SFAS 133.

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STOCK BASED COMPENSATION

Prior to January 1, 2006, the Company accounted for employee stock transactions in accordance with Accounting Principles Board ("APB") Opinion No. 25 "Accounting for Stock Issued to Employees." The Company applied the proforma disclosure requirements of SFAS No. 123 "Accounting for Stock-Based Compensation."

Effective January 1, 2006, the Company adopted SFAS No. 123R "Share Based Payment". This statement is a revision of SFAS Statement No. 123, and supersedes APB Opinion No. 25, and its related implementation guidance. SFAS 123R addresses all forms of share based payment ("SBP") awards including shares issued under employee stock purchase plans, stock options, restricted stock and stock appreciation rights. Under SFAS 123R, SBP awards result in a cost that will be measured at fair value on the awards' grant date, based on the estimated number of awards that are expected to vest that will result in a charge to operations. Consequently during the three months ended March 31, 2006, the Company recognized \$180,835 in expenses, which represents the fair value of stock options that have vested during the period ended March 31, 2006.

For the three months ended March 31, 2005, the Company applied APB Opinion No. 25, "Accounting for Stock Issued to Employees." As required under SFAS No. 148, "Accounting for Stock-based Compensation - Transition and Disclosure," the following table presents pro-forma net income and basic and diluted earnings per share as if the fair value-based method had been applied to all awards during that period.

| | THREE MONTHS ENDED MARCH 31, 2005 ----- |
|--|---|
| Net Loss | \$(2,203,795) |
| Stock-based employee compensation cost, under fair value accounting | (185,278) ----- |
| Pro-forma net loss under Fair Value Method | \$(2,389,073) ----- |
| Loss per share | |
| Basic and Diluted | \$ (1.30) |

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Per share stock-based employee compensation cost, under
 fair value accounting
 Pro-forma loss per share, Basic and Diluted \$ (1.41)

COMMON STOCK PURCHASE WARRANTS

The Company accounts for the issuance of common stock purchase warrants issued with registration rights in accordance with the provisions of EITF 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock."

Based on the provisions of EITF 00-19, the Company classifies as equity any contracts that (i) require physical settlement or net-share settlement or (ii) gives the company a choice of net-cash settlement or settlement in its own shares (physical settlement or net-share settlement). The Company classifies as assets or liabilities any contracts that (i) require net-cash settlement (including a requirement to net cash settle the contract if an event occurs and if that event is outside the control of the company) or (ii) give the counterparty a choice of net-cash settlement or settlement in shares (physical settlement or net-share settlement).

INCOME TAXES

The Company accounts for income taxes under SFAS No. 109, "Accounting for Income Taxes". SFAS No. 109 requires the recognition of deferred tax assets and liabilities for both the expected impact of differences between the financial statements and tax basis of assets and liabilities and for the expected future tax benefit to be derived from tax loss and tax credit carry forwards. SFAS No. 109 additionally requires the establishment of a valuation allowance to reflect the likelihood of realization of deferred tax assets.

NET LOSS PER SHARE

Basic net loss per common share is computed by dividing net loss by the weighted-average number of common shares outstanding during the period. Diluted net loss per common share also includes common stock equivalents outstanding during the period if dilutive. Diluted net loss per common share has been computed by dividing net loss by the weighted-average number of common shares outstanding without an assumed increase in common shares outstanding for common stock equivalents; as such common stock equivalents are anti-dilutive.

As a result of the consummation of the Share Exchange described in Note 1, the Company included 40,001 stock options with an exercise price of \$0.30 per share that it issued to certain employees during 2002 in its calculation of weighted-average number of common shares outstanding for all periods presented.

Net loss per common share excludes the following outstanding options, warrants and preferred stock as their effect would be anti-dilutive:

| | MARCH 31, | |
|----------------|-----------|---------|
| | 2006 | 2005 |
| Options | 438,090 | 197,505 |
| Warrants | 1,289,909 | 155,501 |

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| | | |
|------------------------------|------------|---------|
| Series A Preferred Stock ... | 1,860,650 | -- |
| Series A-1 Preferred Stock . | 11,140,063 | -- |
| | ----- | ----- |
| | 14,728,712 | 353,006 |
| | ===== | ===== |

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In December 2004, the FASB issued SFAS No. 153, "Exchanges of Non-monetary Assets" (SFAS 153). SFAS 153 amends APB Opinion No. 29 to eliminate the exception for non-monetary exchanges of similar productive assets and replaces it with a general exception for exchanges of non-monetary assets that do not have commercial substance. A non-monetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. The provisions of SFAS 153 are effective for non-monetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. Earlier application is permitted for non-monetary asset exchanges occurring in fiscal periods beginning after December 16, 2004. The provisions of this statement are intended be applied prospectively. The adoption of this pronouncement did not have a material effect on the Company's financial statements.

EITF Issue No. 04-8, "The Effect of Contingently Convertible Instruments on Diluted Earnings per Share" reached a consensus that contingently convertible instruments, such as contingently convertible debt, contingently convertible preferred stock, and other such securities should be included in diluted earnings per share (if dilutive) regardless of whether the market price trigger has been met. The consensus became effective for reporting periods ending after December 15, 2004. The adoption of this pronouncement did not have a material effect on the Company's financial statements.

In May 2005, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 154, "Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3" ("SFAS 154"). This Statement replaces APB Opinion No. 20, Accounting Changes, and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements, and changes the requirements for the accounting for and reporting of a change in accounting principle. This Statement applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed.

APB Opinion No. 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. This Statement requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. When it is impracticable to determine the period-specific effects of an accounting change on one or more individual prior periods presented, this Statement requires that the new accounting principle be applied to the balances of assets and liabilities as of the beginning of the earliest period for which retrospective application is practicable and that a corresponding adjustment be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period rather than being reported in an income statement. When it is

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impracticable to determine the cumulative effect of applying a change in accounting principle to all prior periods, this Statement requires that the new accounting principle be applied as if it were adopted prospectively from the earliest date practicable. This Statement is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of this pronouncement did not have a material effect on the Company's financial statements.

On June 29, 2005, the EITF ratified Issue No. 05-2, "The Meaning of 'Conventional Convertible Debt Instrument' in EITF Issue No. 00-19, 'Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock.'" EITF Issue 05-2 provides guidance on determining whether a convertible debt instrument is "conventional" for the purpose of determining when an issuer is required to bifurcate a conversion option that is embedded in convertible debt in accordance with SFAS 133. Issue No. 05-2 is effective for new instruments entered into and instruments modified in reporting periods beginning after June 29, 2005. The adoption of this pronouncement did not have a material effect on the Company's financial statements.

In September 2005, the EITF ratified Issue No. 05-4, "The Effect of a Liquidated Damages Clause on a Freestanding Financial Instrument Subject to EITF Issue No. 00-19, 'Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock.'" EITF 05-4 provides guidance to issuers as to how to account for registration rights agreements that require an issuer to use its "best efforts" to file a registration statement for the resale of equity instruments and have it declared effective by the end of a specified grace period and, if applicable, maintain the effectiveness of the registration statement for a period of time or pay a liquidated damage penalty to the investor. The Company is currently in the process of evaluating the effect that the adoption of this pronouncement may have on its financial statements.

In September 2005, the FASB ratified the Emerging Issues Task Force's ("EITF") Issue No. 05-7, "Accounting for Modifications to Conversion Options Embedded in Debt Instruments and Related Issues," which addresses whether a modification to a conversion option that changes its fair value affects the recognition of interest expense for the associated debt instrument after the modification and whether a borrower should recognize a beneficial conversion feature, not a debt extinguishment if a debt modification increases the intrinsic value of the debt (for example, the modification reduces the conversion price of the debt). This issue is effective for future modifications of debt instruments beginning in the first interim or annual reporting period beginning after December 15, 2005. The adoption of this pronouncement did not have a material effect on the Company's financial statements.

In September 2005, the FASB also ratified the EITF's Issue No. 05-8, "Income Tax Consequences of Issuing Convertible Debt with a Beneficial Conversion Feature," which discusses whether the issuance of convertible debt with a beneficial conversion feature results in a basis difference arising from the intrinsic value of the beneficial conversion feature on the commitment date (which is recorded in the stockholders' equity for book purposes, but as a liability for income tax purposes), and, if so, whether that basis difference is a temporary difference under FASB Statement No. 109, "Accounting for Income Taxes." This Issue should be applied by retrospective application pursuant to Statement 154 to all instruments with a beneficial conversion feature accounted for under Issue 00-27 included in financial statements for reporting periods beginning after December 15, 2005. The adoption of this pronouncement did not have a material effect on the Company's financial statements.

In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments - an amendment of FASB Statements No. 133 and 150." SFAS No. 155 (a) permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation,

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(b) clarifies that certain instruments are not subject to the requirements of SFAS 133, (c) establishes a requirement to evaluate interests in securitized financial assets to identify interests that may contain an embedded derivative

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requiring bifurcation, (d) clarifies what may be an embedded derivative for certain concentrations of credit risk and (e) amends SFAS 140 to eliminate certain prohibitions related to derivatives on a qualifying special-purpose entity. SFAS 155 is applicable to new or modified financial instruments in fiscal years beginning after September 15, 2006, though the provisions related to fair value accounting for hybrid financial instruments can also be applied to existing instruments. Early adoption, as of the beginning of an entity's fiscal year, is also permitted, provided interim financial statements have not yet been issued. We are currently evaluating the potential impact, if any, that the adoption of SFAS 155 will have on our consolidated financial statements.

In March 2006, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 156, Accounting for Servicing of Financial Assets (SFAS No. 156). SFAS No. 156 amends SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," to require all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable. SFAS No. 156 also permits servicers to subsequently measure each separate class of servicing assets and liabilities at fair value rather than at the lower of cost or market. For those companies that elect to measure their servicing assets and liabilities at fair value, SFAS No. 156 requires the difference between the carrying value and fair value at the date of adoption to be recognized as a cumulative effect adjustment to retained earnings as of the beginning of the fiscal year in which the election is made. SFAS No. 156 is effective for the first fiscal year beginning after September 15, 2006. We are currently evaluating the potential impact, if any, that the adoption of SFAS 156 will have on our consolidated financial statements.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies that do not require adoption until a future date are not expected to have a material impact on the consolidated financial statements upon adoption.

NOTE 6 - BUSINESS COMBINATIONS

On February 25, 2005, the Company acquired Complete Security Solutions, Inc. ("CSSI") and LucidLine, Inc. ("LucidLine") in separate merger transactions. Additionally, on March 30, 2005, the Company acquired Entelagent Software Corp. ("Entelagent") in a merger transaction. The Company accounted for these business combinations in accordance with the provisions of SFAS 141 "Accounting for Business Combinations."

In connection with these three merger transactions, the Company paid, \$200,000 in cash, 496,667 shares of common stock with a fair market value of \$12,665,000, subordinated promissory notes in the aggregate principal amount of \$4,500,000, warrants to purchase up to 75,000 shares of common stock which were valued at \$1,912,500. Direct expenses incurred by the Company to complete these transactions amounted to \$912,663. The total purchase price for the three companies amounted to \$20,190,133.

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| | CSSI | LUCIDLINE | ENTEAGENT | TOTAL |
|-------------------------------|--------------|--------------|--------------|--------------|
| | ----- | ----- | ----- | ----- |
| Cash | \$ -- | \$ 200,000 | \$ -- | \$ 200,000 |
| Common Stock | 6,375,000 | 3,740,000 | 2,550,000 | 12,665,000 |
| Subordinated promissory notes | 4,500,000 | -- | -- | 4,500,000 |
| Common stock warrants | 1,912,500 | -- | -- | 1,912,500 |
| Transaction expenses | 398,128 | 154,611 | 359,894 | 912,633 |
| | ----- | ----- | ----- | ----- |
| Total Purchase Price | \$13,185,628 | \$ 4,094,611 | \$ 2,909,894 | \$20,190,133 |
| | ===== | ===== | ===== | ===== |

The allocation of the purchase price was based upon a valuation study performed by an independent outside appraisal firm. The purchase price allocation resulted in the allocation of \$3,101,000 to intangible assets, including \$2,570,000 to developed technology and \$190,000 to in-process research and development. Additionally, the purchase price allocation resulted in the allocation of \$22,440,412 to goodwill.

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The Company performed its annual impairment test of goodwill at its designated valuation date of December 31, 2005 in accordance with SFAS 142. As a result of these tests, the Company determined that the recoverable amount of goodwill with respect to its business amounted to \$9,510,716. Accordingly, the Company recorded a goodwill impairment charge in the amount of \$12,929,696 for the year ended December 31, 2005. Additionally, after reevaluating the resources available to the Company, the strategic direction of the business as well as the revised business plans and financial projections, the Company, during the quarter ended December 31, 2005, recorded a \$1,705,455 charge for the impairment of the developed technology assets acquired in the CSSI and Entelagent acquisitions. The remaining amount of goodwill and intangible assets is presented net of such impairment charges recorded during the year ended December 31, 2005.

NOTE 7 - OTHER CURRENT ASSETS

Other current assets consist of the following:

| | MARCH 31 |
|----------------------------|------------|
| | 2006 |
| | ----- |
| Employee receivables | \$ 75,877 |
| Prepaid expenses | 36,443 |
| Deposits | 23,739 |
| | ----- |
| Other current assets | \$ 135,059 |
| | ===== |

NOTE 8 - PROPERTY AND EQUIPMENT

MARCH 31
2006

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| | |
|--------------------------------------|------------|
| Computers | \$ 107,897 |
| Furniture and Fixtures | 32,887 |
| Leasehold improvements | 4,490 |
| | ----- |
| sub-total | 145,274 |
| less: accumulated depreciation | (43,730) |
| | ----- |
| Property and equipment, net | \$ 101,544 |
| | ===== |

Depreciation expense amounted to \$20,664 and \$295 for the three months March 31, 2006 and March 31, 2005, respectively.

NOTE 9 - INTANGIBLE ASSETS

The components of intangible assets as of March 31, 2006 are set forth in the following table:

| | |
|---|-------------------|
| | MARCH 31, 2006 |
| | ----- |
| Developed technology | \$ 2,570,000 |
| Customer relationships | 180,000 |
| Trademarks and tradenames | 161,000 |
| In-process research and development | 735,681 |
| | ----- |
| | 3,646,681 |
| Amortization and impairment charge | (2,260,964) |
| | ----- |
| Intangible assets, net | \$ 1,385,717 |
| | ===== |

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During the year ended December 31, 2005, the Company recorded a \$1,705,455 charge for the impairment of the developed technology assets acquired in the CSSI and Entelagent acquisitions (Note 6).

The Company classifies amortization of developed technology as a component of cost of sales and amortization of customer relationship and trademarks and tradenames as a component of general and administrative expense. Amortization expense amounted to \$58,336 for the three months ended March 31, 2006, including \$27,522 classified in cost of sales.

NOTE 10 - DEMAND NOTES PAYABLE

Through December 31, 2004, the Company borrowed an aggregate amount of \$695,000 from several unrelated parties. At March 31, 2006, the outstanding balance on these notes amounted to \$135,000. These notes are payable on demand and bear interest at the rate of 10% per annum. Interest expense on these notes amounted to \$17,375 for each of the three months ended March 31, 2006 and 2005, respectively.

Other demand notes at March 31, 2006 total \$336,056 and include a note payable to Lok Technology in the amount of \$312,556 which is secured by Entelagent's accounts receivable and bears interest at 15% per annum. Interest on these other

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demand notes amounted to \$13,433 for the three months ended March 31, 2006 and \$0 for the three months ended March 30, 2005.

As of March 31, 2006, \$585,000 of the Demand Notes have been surrendered as payment for Series A-1 Preferred stock as part of the creditor and claimant liabilities restructuring (Note 17). Subsequent to March 31, 2006, \$169,212 of the Demand Notes have been surrendered as payment for Series A-1 Preferred stock as part of the creditor and claimant liabilities restructuring (Note 17).

NOTE 11 - BRIDGE NOTES PAYABLE

INTERIM BRIDGE FINANCING I

On February 28, 2005, the Company completed a \$3,500,000 financing (the "Interim Bridge Financing I") through the issuance of 10% Senior Convertible Promissory Notes (the "Bridge I Notes") and warrants to purchase up to 58,334 shares of the Company's common stock ("Bridge I Warrants"). The warrants have a term of 5 years and an exercise price of \$21.00 per share. The aggregate fair value of the Bridge I Warrants amounts to \$1,487,500. Prior to final maturity, the Bridge I Notes may be converted into securities that would be issuable at the first closing of a subsequent financing by the Company, for such number of offered securities that could be purchased for the principal amount being converted. The Bridge I Notes had an initial term of 120 days (due on June 28, 2005) with interest at a contractual rate of 10% per annum and featured an option for the Company to extend the term for an additional 60 days to August 27, 2005.

In accordance with APB 14, "Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants," the Company allocated \$2,456,140 of the proceeds to the Bridge I Notes and \$1,043,860 of proceeds to the Bridge I Warrants. The difference between the carrying amount of the Bridge I Notes and their contractual redemption amount was accreted as interest expense to June 28, 2005, their earliest date of redemption.

On June 28, 2005, the Company elected to extend the contractual maturity date of the Bridge I Notes for an additional 60 days to August 27, 2005, which caused the contractual interest rate to increase to 12% per annum. In addition, the Company was required to issue the 58,334 additional warrants (the "Bridge I Extension Warrants") to purchase such number of shares of common stock equal to 1/60 of a share for each \$1.00 of principal amount outstanding. The Bridge I Extension Warrants have a term of 5 years and an exercise price of \$21.00 per share. The Bridge I Extension Warrants have a fair value of \$822,500. Assumptions relating to the estimated fair value of these warrants are as follows: fair value of common stock of \$19.50; risk-free interest rate of 4.25%; expected dividend yield zero percent; expected warrant life of three years; and current volatility of 125%.

The Company did not redeem the Bridge I Notes on August 27, 2005 and, as a result, the notes became automatically convertible into 0.128 shares of common stock for each \$1 of principal then outstanding in accordance with the original note agreement. Accordingly, the Company recorded a charge of \$3,500,000 in 2005 based upon the intrinsic value of this conversion option measured at the original issuance date of the note in accordance with EITF 00-27. The Company has agreed to file with the SEC, a registration statement for the resale of the restricted shares of the Company's common stock issuable upon exercise of the conversion option that would be issued in this transaction, on a best efforts basis.

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Contractual interest expense on the Bridge I Notes amounted to \$103,562 and \$29,167 for the three months ended March 31, 2006 and 2005, respectively, and is included as a component of interest expense in the accompanying statement of operations.

As of March 31, 2006, \$3,155,025 of the Bridge I Notes have been surrendered as payment for Series A-1 Preferred stock as part of the creditor and claimant liabilities restructuring (Note 17).

INTERIM BRIDGE FINANCING II

On June 6, 2005, the Company completed a \$2,543,000 financing (the "Interim Bridge Financing II") through the issuance of (i) 10% Junior Convertible Promissory Notes (the "Bridge II Notes") and (ii) warrants to purchase up to 42,384 shares of common stock (the "Bridge II Warrants"). The warrants have a term of 5 years and an exercise price of \$18.00 per share. The aggregate fair value of the Bridge II Warrants amounts to \$673,895. Prior to maturity, the Junior Convertible Promissory Notes may be converted into the securities offered by the Company at the first closing of a subsequent financing for the Company, for such number of offered securities as could be purchased for the principal amount being converted.

In accordance with APB 14, the Company allocated \$2,010,277 of the proceeds to the Bridge II Notes and \$532,723 of proceeds to the Bridge II Warrants. The difference between the carrying amount of the Bridge II Notes and their contractual redemption amount is being accreted as interest expense to October 3, 2005, their earliest date of redemption.

The Bridge II Notes have an initial term of 120 days (due on various dates beginning October 3, 2005) with interest at 10% per annum and feature an option for the Company to extend the term for an additional 60 days to various dates beginning December 2, 2005. Upon the extension of the maturity date of the Bridge II Notes, the contractual interest rate would increase to 12% per annum, and the Company would be required to issue warrants (the "Bridge II Extension Warrants") to purchase such number of shares of the Company's common stock equal to 1/60 of a share for each \$1.00 of principal then outstanding. The Bridge II Extension Warrants issuable upon extension of the maturity date of the Junior Convertible Promissory notes feature a term of 5 years and an exercise price of \$18.00 per share. The Bridge II Extension Warrants have a fair value of \$65,388. Assumptions relating to the estimated fair value of these warrants are as follows: fair value of common stock \$2.40; risk-free interest rate of 3.10%; expected dividend yield zero percent; expected warrant life of five years; and current volatility of 125%. In addition, if the Bridge II Notes are not paid in full on or before the extended maturity date, each note becomes convertible into 0.128 shares of the Company's common stock for each \$1.00 of principal then outstanding. The intrinsic value of this conversion option measured at the issuance date of the notes amounts to \$2,543,000 and would be recognized as interest expense in accordance with EITF 00-27. The Company has agreed to file with the SEC, a registration statement for the resale of the restricted shares of its common stock issuable upon exercise of the conversion option that would be issuable in this transaction, on a best efforts basis.

The Company sold these securities to seven accredited investors introduced by Laidlaw, placement agent in the Interim Bridge Financing II. The Company incurred \$386,027 of fees in connection with this transaction including a cash fee of \$305,160 and \$80,867 for the fair value of warrants to purchase 5,086 shares of the Company's common stock at an exercise price of \$18.00 per share.

The Company elected to extend the due dates of these notes by an additional 60 days to various dates beginning December 2, 2005.

Contractual interest expense on the Bridge II Notes amounted to \$75,245 for the three months ended March 31, 2006 and is included as a component of interest expense in the accompanying statement of operations.

As of March 31, 2006, \$1,343,000 of the Bridge II Notes have been surrendered as payment for Series A-1 Preferred stock as part of the creditor and claimant liabilities restructuring (Note 17).

INTERIM BRIDGE FINANCING III

Beginning on July 1, 2005, and continuing through December 31, 2005, the Company completed, through 12 separate fundings, a \$5,234,000 financing (the "Interim Bridge Financing III") through the issuance of (i) 10% Junior Convertible Promissory Notes (the "Bridge III Notes") and (ii) warrants to purchase up to 87,234 shares of common stock (the "Bridge III Warrants"). The warrants have a term of 5 years and an exercise price of \$18.00 per share. Prior to maturity, the Junior Convertible Promissory Notes may be converted into the securities offered by the Company at the first closing of a subsequent financing for the Company, for such number of offered securities as could be purchased for the principal amount being converted.

In accordance with APB 14, the Company allocated \$4,645,544 of the proceeds to the Bridge III Notes and \$587,595 of proceeds to the Bridge III Warrants. The difference between the carrying amount of the Bridge III Notes and their contractual redemption amount is being accreted as interest expense to various dates from November 1, 2005, their earliest date of redemption. Accretion of the aforementioned discount amounted to \$20,909 for the three months ended March 31, 2006 and is included as a component of interest expense in the accompanying statement of operations.

The Bridge III Notes have an initial term of 120 days (due on various dates beginning October 28, 2005) with interest at 10% per annum and feature an option for the Company to extend the term for an additional 60 days to various dates beginning December 28, 2005. Upon the extension of the maturity date of the Bridge III Notes, the contractual interest rate would increase to 12% per annum, and the Company would be required to issue warrants (the "Bridge III Extension Warrants") to purchase such number of shares of the Company's common stock equal to 1/60 of a share for each \$1.00 of principal then outstanding. The Bridge III Extension Warrants issuable upon extension of the maturity date of the Junior Convertible Promissory Notes feature a term of 5 years and an exercise price of \$18.00 per share. In addition, if the Bridge III Notes are not paid in full on or before the extended maturity date, each note becomes convertible into 0.128 shares of the Company's common stock for each \$1.00 of principal then outstanding. The intrinsic value of this conversion option measured at the issuance date of the notes amounts to \$5,234,000 and would be recognized as interest expense in accordance with EITF 00-27. The Company has agreed to file with the SEC, a registration statement for the resale of the restricted shares of its common stock issuable upon exercise of the conversion option that would be issuable in this transaction, on a best efforts basis.

Beginning on October 29, 2005, the Company elected to extend the contractual maturity date of the various Bridge III Notes for an additional 60 days to various dates beginning December 28, 2005, which caused the contractual interest rate to increase to 12% per annum. In addition, during the three month ended March 31, 2006, the Company was required to issue 39,917 additional warrants (the "Bridge III Extension Warrants"). The aggregate fair value of the warrants, which amounted to \$48,129 was recorded as a deferred financing cost and was

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being amortized over the 60-day extension period or until March 27, 2006 when the Bridge III Notes were surrendered as payment for the Series A-1 Preferred stock under the creditor and claimant liabilities restructuring. The Bridge III Extension Warrants have a term of 5 years and an exercise price of \$18.00 per share. Assumptions relating to the estimated fair value of these warrants are as follows: fair value of common stock \$1.95 to \$2.40; risk-free interest rate of 3.10% to 3.44%; expected dividend yield zero percent; expected warrant life of three years; and current volatility of 125%.

The Company did not redeem the Bridge III Notes beginning on December 28, 2005 and, as a result, the notes became automatically convertible into 0.128 shares of common stock for each \$1 of principal then outstanding in accordance with the original note agreement. This amounts to a total of 70,400 shares during the three months ended of March 31, 2006. Accordingly, the Company recorded a charge of \$192,000, in the three months ended March 31, 2006, based upon the intrinsic value of this conversion option measured at the original issuance date of the notes in accordance with EITF 00-27. With the surrender of the Bridge III Notes in payment for Series A-1 Preferred stock under the creditor and claimant liabilities restructuring, these conversion options are no longer exercisable and have been cancelled.

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Contractual interest expense on the Bridge III Notes amounted to \$144,036 for the three months ended March 31, 2006 and is included as a component of interest expense in the accompanying statement of operations.

The Company sold these securities to Apex, Northwestern, and Advanced Equities. Funding for the Bridge III Notes included the conversion of \$1,650,000 of stockholder advances made during the period March 30, 2005 to June 30, 2005 into Bridge III Notes.

As of March 31, 2006, all of the Bridge III Notes have been surrendered as payment for Series A-1 Preferred stock as part of the creditor and claimant liabilities restructuring (Note 17).

2006 BRIDGE NOTES

On January 18, 2006, the Company completed a financing of approximately \$540,000 in additional gross funds (the "2006 Bridge Note Financing") through the issuance of Subordinated Convertible Promissory Notes (the "2006 Bridge Notes") in the amount of \$720,001. The 2006 Bridge Note agreement provided for these notes to automatically convert into the same securities (consisting of shares of Series A Preferred stock and warrants to purchase shares of the Company's common stock) offered by the Company in connection with its Series A Preferred Financing. On March 27, 2006 (the date of the first closing of the Series A Preferred Financing), the 2006 Bridge Notes were converted into 7.2 Units in the Series A Preferred Financing described below. The \$180,000 difference between the gross proceeds received upon the original issuance of the notes and the redemption amount was recorded as an original issuance discount that was fully expensed during the three months ended March 31, 2006.

Additionally, the Company paid Laidlaw & Company (UK) Ltd. (Laidlaw), as placement agent in the transaction, a fee of \$54,000 in conjunction with the 2006 Bridge Note Financing. This fee was fully amortized and recognized as interest expense during the three months ending March 31, 2006.

NOTE 12 - RELATED PARTY TRANSACTIONS

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EXPENSE REIMBURSEMENTS DUE TO OFFICERS AND STOCKHOLDERS

Certain stockholders and officers of the Company have paid expenses on the Company's behalf since its inception, of which \$166,183 remains outstanding at March 31, 2006. The amounts payable to such officers and stockholders are due on demand. The balance due under these arrangements is included in the liabilities that the Company has offered to settle under the creditor and claimant liabilities restructuring described in Note 17. Subsequent to March 31, 2006, \$13,501 of this amount has been surrendered as payment for Series A-1 Preferred stock under the creditor and claimant liabilities restructuring.

NOTES PAYABLE TO OFFICERS AND STOCKHOLDERS

Notes payable to officers and stockholders which amount to \$235,712 bear interest at 10% per annum and are due on demand. Interest expense on these notes amounted to \$4,725 for the three months ended March 31, 2006. The balance due under these notes is included in the liabilities that the Company has offered to settle under the creditor and claimant liabilities restructuring described in Note 17.

CONSULTING AGREEMENT PAYABLE

On June 8, 2005, the Company negotiated a settlement regarding a consulting agreement payable with a related party. The terms of the settlement agreement terminated the prior agreement and reduced the remaining payments due under the contract to \$150,000 including a \$50,000 payment that was made upon the execution of the agreement and two additional \$50,000 payments including one to be made upon the completion of a follow-on-financing by the Company and one not later than September 30, 2005. The \$150,000 reduction in payments was recorded as a reduction of general and administrative expense during the quarter ended June 30, 2005. Additionally, the settlement agreement terminated an obligation for the Company to issue 3,334 shares of unrestricted stock. The stock issuable

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under this commitment was recorded in 2004 as common stock issued in lieu of cash for services in the amount of \$78,900. The rescission of the stock issuable under this arrangement resulted in an additional reduction of \$78,900 in general and administrative expenses during the year ended December, 31, 2005.

The payment due on September 30, 2005 was not made by the Company. The \$100,000 balance due under this arrangement has been surrendered as payment for Series A-1 Preferred stock under the creditor and claimant liabilities restructuring described in Note 17.

NOTES PAYABLE (TO CREDITORS OF ACQUIRED BUSINESS)

The notes issued to creditors of Entelagent described in Note 6, include \$1,538,129 payable to related parties for settlement of accrued payroll, notes payable and expense reimbursements at March 31, 2006. Aggregate interest expense on these notes amounted to \$51,111 and \$0 for the three months ended March 31, 2006 and 2005, respectively. The balance due under these notes is included in the liabilities that the Company has offered to settle under the creditor and claimant liabilities restructuring described in Note 17.

During the three months ended March 31, 2006, \$812,002 of the notes payable to creditors of acquired business was surrendered as payment for Series A-1 Preferred stock under the creditor and claimant liabilities restructuring.

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Subsequent to March 31, 2006, an additional \$983,928 has been surrendered as payment for Series A-1 Preferred stock under the creditor and claimant liabilities restructuring.

NOTE 13 - OTHER CURRENT LIABILITIES

Other current liabilities principally consists of \$445,778 of accrued payroll and sales tax liabilities and estimated penalties that the Company assumed in its acquisition of Entelagent (Note 6).

NOTE 14 - DEFERRED REVENUE

Deferred revenue at March 31, 2006 includes (1) \$87,781 for the fair value of remaining service obligations on maintenance and support contracts and (2) \$102,228 for contracts on which the revenue recognition is deferred until contract deliverables have been completed.

NOTE 15 - ACCOMMODATION AGREEMENT

In November 2002, the Company entered into a financing arrangement with a third party financial institution (the "Lender"), pursuant to which the Company would borrow \$950,000 under a note to be collateralized by the pledge of 31,667 shares of registered stock from five different stockholders. In connection with this arrangement, the Company executed a series of Accommodation Agreements with these stockholders wherein each stockholder pledged their shares in return for the right to receive on or before November 17, 2003 the return of the pledged shares, or replacement shares in the event of foreclosure, and one additional share of common stock for every four shares pledged as compensation. The Company also agreed to use "best efforts" to register these shares with the US Securities and Exchange Commission 12 months from the date of issue.

In December 2002, the Company received approximately \$450,000 of proceeds under the note and provided the Lender the pledged shares. Since that date, no additional proceeds were provided by the Lender and repeated attempts were made by the Company to secure the additional proceeds. The Company has effectively accounted for the Lender's failure to fund the facility and return the pledged shares as a foreclosure on the loan collateral. Accordingly, the Company recorded a \$1,047,728 loss during the year ended December 31, 2002.

On March 13, 2003, the Company issued 40,000 replacement shares with an aggregate fair value of \$3,708,000 to the stockholders who pledged their shares under the Accommodation Agreements. Accordingly, the Company recorded an additional loss of \$2,210,272 during the year ended December 31, 2003 for the difference between the

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loss the Company recorded upon the Lender's foreclosure of the collateral and the aggregate fair value of the replacement shares.

In addition, the Accommodation Agreements provided for the Company to pay a penalty in the event of its failure to cause the replacement shares to be registered on or before March 31, 2003. As a result, the Company has recorded stock based penalties for the fair value of 15,000 shares per quarter through December 31, 2005.

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The total stock-based penalties associated with the Accommodation Agreements from April 2003 to December 31, 2005 were \$3,318,975. An aggregate of 165,000 shares were issuable through December 31, 2005 under the stock-based penalties associated with the Accommodation Agreements.

On March 27, 2006, the Company entered into an agreement to release and resolve all outstanding claims between the parties under the creditor and claimant liabilities restructuring (Note 17).

STOCK PLEDGE ARRANGEMENT

In April 2004, a stockholder of the Company entered into a one-year stock loan financing arrangement ("Stock Financing Facility") with a third party financial institution (the "Lender I"), pursuant to which such stockholder committed to obtain financing for the Company under a credit facility collateralized by the pledge of 22,834 shares of registered stock (the "Pledged Stock") that was pledged by a second stockholder (the "Pledging Stockholder"). In connection with this arrangement, the Company executed an accommodation agreement with the Pledging Stockholder committing to issue 22,834 shares of restricted stock (the "Replacement Stock") on April 2, 2005 (the "Termination Date") in the event of a loss of the Pledged Stock, plus a premium of 6,850 shares (the "Premium Shares") for entering into the agreement. The Company also agreed to register 10,000 shares of restricted stock held by the Pledging Stockholder (the "Held Stock") within thirty days of the agreement and to use its best efforts register with the SEC, both the Replacement Stock and Premium Stock within 12 months from their date of issue.

The Company received \$40,012 of funds but was unable to recover the Pledged Stock on the Termination Date. In addition, due to a delay in registering all of the shares under this arrangement, the Company entered into a secondary agreement with the Pledging Stockholder providing for: (1) the immediate issuance of the Replacement Shares and Premium Shares; (2) registration of the Replacement Shares, Premium Shares and Held Shares; (3) the retroactive accrual of a penalty from May 2, 2004 through the date the registration statement is filed payable in such number of shares that is equal to 15% of the Held Stock (prorated for each fraction of a year); and (4) the accrual of an additional penalty from April 2, 2005 through the date the registration statement is filed equal to 15% of the Replacement Stock and Premium Stock (prorated for each fraction of a year).

The Company recorded a charge of \$406,205 for the fair value of the Replacement Stock and Premium Stock (29,684 shares) issued to the Pledging Stockholder under this arrangement. Such charge, net of \$40,012 of advances received, is presented as a loss on collateralized financing arrangement in the accompanying statement of operations. The Company also recorded charges of \$2,852 and \$9,014 during the three months ended March 31, 2006 and 2005, respectively for the fair value of 1,501 and 370 shares issuable during the three months ended March 31, 2006 and 2005, respectively to the Pledging Stockholder as penalties for the delays in registering the stock. The charges associated with the penalties are included in stock based penalties under accommodation agreements in the accompanying statements of operations.

NOTE 16 - COMMITMENTS AND CONTINGENCIES

SEC INVESTIGATION

Pursuant to Section 20(a) of the Securities Act and Section 21(a) of the Securities Exchange Act, the staff of the SEC (the "Staff"), issued an order (In the Matter of Patron Systems, Inc. - Order Directing a Private Investigation and Designating Officers to Take Testimony (C-03739-A, February 12, 2004)) (the "Order") that a private investigation (the "SEC Investigation") be made to

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determine whether certain actions of, among others, the Company, certain of its officers and directors and others violated Section 5(a) and 5(c) of the Securities Act and/or

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Section 10 and Rule 10b-5 promulgated under the Exchange Act. Generally, the Order provides, among other things, that the Staff is investigating (i) the legality of two (2) separate Registration Statements filed by the Company on Form S-8, filed on December 20, 2002 and on April 2, 2003, as amended on April 9, 2003 (collectively, the "Registration Statements"), covering the resale of, in the aggregate, 145,834 shares of common stock issued to various consultants of the Company, and (ii) whether in connection with the purchase or sale of shares of common stock, certain officers and directors of the Company and others (a) sold common stock in violation of Section 5 of the Securities Act and/or, (b) made misrepresentations and/or omissions of material facts and/or employed fraudulent devices in connection with such purchases and/or sales relating to certain of the Company's press releases regarding, among other items, proposed mergers and acquisitions that were never consummated. If the SEC brings an action against the Company, it could result in, among other items, a civil injunctive order or an administrative cease-and-desist order being entered against the Company, in addition to the imposition of a significant civil penalty. Moreover, the SEC Investigation and/or a subsequent SEC action could affect adversely the Company's ability to have its common stock become listed on a stock exchange and/or quoted on the NASD Bulletin Board or NASDAQ, the Company being able to sell its securities and/or have its securities registered with the SEC and/or in various states and/or the Company's ability to implement its business plan. To date, the Company's legal counsel representing the Company in such matters has indicated that the SEC Investigation is ongoing and the Staff has not indicated whether it will or will not recommend that the SEC bring an enforcement action against the Company, its officers, directors and/or others.

LEGAL PROCEEDINGS

Sherleigh Associates Inc. Profit Sharing Plan ("Sherleigh") filed a complaint against the Company, Patrick Allin, former Chief Executive Officer of the Company, and Robert E. Yaw, the Company's non-executive Chairman, on February 3, 2004, in the United States District Court for the Southern District of New York (the "Court") alleging common law fraud. The complaint alleged that Sherleigh was fraudulently induced into purchasing 33,334 shares of Company common stock in reliance upon certain of the Company's press releases and allegedly false statements by Mr. Allin and Mr. Yaw, concerning the Company's plans to acquire two target companies, TrustWave Corporation (currently a strategic partner of the Company) and Entelagent (a current subsidiary of the Company), and its financing arrangements regarding those acquisitions. Sherleigh seeks rescission of its purchase agreement and return of its \$2,000,000 purchase price or compensatory damages to be proven at trial. Mr. Allin recently entered into a settlement agreement with Sherleigh and is requesting that the Court include in its dismissal order a finding that the settlement is reasonable and a prohibition against any claims by the Company or Mr. Yaw against Mr. Allin for contribution or indemnification with respect to Sherleigh's claims. The Company has opposed Mr. Allin's request. The Court has not yet issued any ruling on Mr. Allin's request. Discovery has been completed, but no trial date has been set by the Court. The Company believes the Plaintiff's claims are without merit and intends to continue to defend against them through trial, if necessary. The amount of loss, if any, with respect to the claim cannot be predicted or quantified at this time and, therefore, no amounts have been recorded on the books of the Company. On April 24, 2006, the Company and the Sherleigh Associates Inc. Profit Sharing Plan entered into a final and binding settlement

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of all claims (Note 21).

On January 5, 2006, Mark P. Gertz, Trustee in bankruptcy for Arter & Hadden, LLP, filed an Adversary Complaint for Recovery of Assets of the Estate in the United States Bankruptcy Court Northern District of Ohio Eastern Division, against the Company as successor in merger to Entelagent. Mr. Gertz seeks \$32,278.18 plus interest accruing at the statutory rate since July 15, 2003 for services rendered by Arter & Hadden, LLP to Entelagent. The Company intends to respond to this complaint within the time allotted by statute. The Company intends to attempt to settle this claim as part of the creditor and claimant liabilities restructuring (Note 17).

While the Company believes it has defenses to the claims noted above, notwithstanding the fact that the Company intends to vigorously defend these actions, there can be no assurance the Company will be successful in its defense of any of these claims. In the event the Company is required to pay damages in connection with any one or more of the claims asserted in these actions, such payment could have a material adverse effect on the Company's business and operations.

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GRAUL CLAIM

On March 3, 2006, the Company, Ms. Graul and a third party ("Buyer") entered into an arrangement providing for Ms. Graul to assign and transfer all rights, title and interest in her original claim of \$931,659 against the Company to the Buyer in exchange for a cash payment in the amount of \$180,000. On March 15, 2006, the Company advanced the \$180,000 payment to Ms. Graul in exchange for her immediate release of all claims against the Company. The Company is currently awaiting payment in the same amount from the Buyer in order to complete the assignment of such claim to the Buyer. This arrangement further provides for the Company to acknowledge Ms. Graul's original claim for the benefit of the Buyer, the rescission of the August 2005 settlement and release, and for the Buyer to participate in the creditor and claimant liabilities restructuring (Note 17) with respect to the settlement of Ms. Graul's original claim.

STOCK SUBSCRIPTION AND MUTUAL RELEASE AGREEMENTS WITH PATRICK ALLIN AND THE ALLIN DYNASTIC TRUST

On January 1, 2006, the Company and Mr. Patrick Allin and The Allin Dynastic Trust entered into Stock Subscription Agreement and Mutual Release agreements (the "Series A-1 Agreements") to settle all claims in law, equity, or otherwise ("Allin Subscriber Claims") arising out of the business relationship between the parties that Mr. Allin and The Allin Dynastic Trust may have with the Company. The Series A-1 Agreements provide for the issuance of 1,875,000 shares of Series A-1 Preferred Stock to Mr. Allin and 625,000 shares of Series A-1 Preferred Stock to The Allin Dynastic Trust. The aggregate purchase price is equivalent to the value of the Allin Subscriber Claims being settled through this settlement and release. The total of these claims at December 31, 2005 amounted to \$2,000,000. Mr. Allin and The Allin Dynastic Trust are each deemed to have paid for the Series A-1 Preferred Stock through the settlement and release of Allin Subscriber Claims. See Note 18 for further details of the Series A-1 Preferred stock and Note 17 for the creditor and claimant liabilities restructuring.

SETTLEMENT OF LINTING LAWSUIT

On February 14, 2006, the Company and Richard Linting entered into a Stock Subscription Agreement & Mutual Release ("Linting Agreement") to settle all

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claims in law, equity or otherwise ("Linting Subscriber Claims") arising out of the business relationship between the parties that Mr. Linting may have with the Company. The Linting Agreement provides for the issuance of 1,777,261 shares (the "Shelved Stock") of Series A-1 Preferred stock. The aggregate purchase price is equivalent to the value of the Linting Subscriber Claims being settled through this settlement and release. The total set aside purchase price for the Shelved Stock shall be \$0.80 per share or an aggregate of \$1,421,809. Mr. Linting is deemed to have paid for the Series A-1 Preferred stock through the settlement and release of the Linting Subscriber Claims. This agreement provides for the transfer of the Shelved Stock in stock certificate installments and in such numbers and at such times as directed by Mr. Linting. See Note 18 for further details of the Series A-1 Preferred stock and Note 17 for the creditor and claimant liabilities restructuring.

SETTLEMENT OF HARARY, ET AL. LAWSUITS

On March 27, 2006, the Company reached agreement with Paul Harary, Paris McKinzie, Maria Caporicci, LLB Ltd. and DGC, Inc. (the "Subscribers") whereby each of the Subscribers and the Company mutually release the other party and its respective stockholders, directors, officers, employees, etc. from any and all past, present and future claims that can or have been brought by the other party relating to any act or omission occurring on or prior to the date of the Agreement. Additionally, the Company agreed to a payment to the Subscribers, including attorneys' fees, of \$125,090. The Subscribers agreed to purchase from the Company 3,000,000 shares of the Company's Series A-1 Preferred Stock, the purchase price for the stock shall be \$0.80 per share and shall be paid through this settlement and release of \$2,400,000 of Subscriber claims. See Note 18 for further details of the Series A-1 Preferred stock and Note 17 for the creditor and claimant liabilities restructuring.

BRADEN WAVERLEY, CHIEF OPERATING OFFICER - EMPLOYMENT AGREEMENT

On February 17, 2006, the Company entered into an employment agreement (the "Waverley Agreement") with Braden Waverley ("Waverley"), the Company's new Chief Operating Officer. The term of the Waverley Agreement

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is one year with automatic one-year renewal unless Mr. Waverley is provided with written notice of non-renewal 90 days prior to expiration of the current term of the Waverley Agreement. The Waverley Agreement provides for a base salary of \$200,000 per year. The Waverley Agreement provides for a performance bonus determined in accordance with revenue milestones established by the Board of Directors on a quarterly basis. Mr. Waverley is eligible to receive a bonus of up to 75% of base salary for each quarter that the Company achieves the agreed upon revenue milestones. Additionally, the Waverley Agreement provides for the grant of stock options in an amount representing an aggregate 3.5% of the outstanding shares of Company common stock on the date of grant ("Waverley Initial Grant"). The Waverley Initial Grant is for 73,371 shares at an exercise price of \$1.65 per share. Additionally, Mr. Waverley will be granted an additional option ("Waverley Additional Option") intended to be made under the terms of the Employment Agreement as an antidilutive grant, following the Company's completion of its recapitalization under the creditor and claimant liabilities restructuring program and the effectiveness of a registration statement for the resale of such shares so that Mr. Waverley would retain options to purchase up to 3.5% of the Company's fully diluted common stock. Mr. Waverley's Employment Agreement also provided for the grant of an additional option to purchase that number of shares of the Company's common stock representing an aggregate of 3.5% of the outstanding shares of the Company's

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common stock on a fully-diluted basis upon his intended appointment as the Company's Chief Executive Officer. These options have a term of 10 years and vest 20% on the date of grant and 1/48th of the balance on the last day of each month for the next 48 months following the effective date of this agreement.

MARTIN T. JOHNSON, CHIEF FINANCIAL OFFICER - EMPLOYMENT AGREEMENT

On February 17, 2006, the Company entered into an employment agreement (the "Johnson Agreement") with Martin T. Johnson ("Johnson"), the Company's new Chief Financial Officer. The term of the Johnson Agreement is one year with automatic one-year renewal unless Mr. Johnson is provided with written notice of non-renewal 90 days prior to expiration of the current term of the Johnson Agreement. The Johnson Agreement provides for a base salary of \$180,000 per year. The Johnson Agreement provides for a performance bonus determined in accordance with revenue milestones established by the Board of Directors on a quarterly basis. Mr. Johnson is eligible to receive a bonus of up to 50% of base salary for each quarter that the Company achieves the agreed upon revenue milestones. Additionally, the Johnson Agreement provides for the grant of stock options in an amount representing an aggregate 1.25% of the outstanding shares of Company common stock on the date of grant ("Johnson Initial Grant"). The Johnson Initial Grant is for 26,204 shares at an exercise price of \$1.65 per share. Additionally, Mr. Johnson will be granted an additional option ("Johnson Additional Option") intended to be made under the terms of the Employment Agreement as an antidilutive grant, following the Company's completion of its recapitalization under the creditor and claimant liabilities restructuring program and the effectiveness of a registration statement for the resale of such shares so that Mr. Johnson would retain options to purchase up to 1.25% of the Company's fully diluted common stock. These options have a term of 10 years and vest 20% on the date of grant and 1/48th of the balance on the last day of each month for the next 48 months following the effective date of this agreement.

ROBERT CROSS - BONUS ARRANGEMENT

On March 7, 2006, the Patron Board of Directors, in executive session without Mr. Cross being present, approved a bonus arrangement ("Bonus Arrangement") for Mr. Cross. The Bonus Arrangement provides for (i) a cash bonus equal to \$200,000, grossed up for taxes (the "Cash Bonus"), (ii) the Cash Bonus would be payable only after agreement has been reached with creditors holding the applicable percentage of Patron's creditor obligations agree to convert their obligations under the creditor and claimant liabilities restructuring and when the funding escrow established by Laidlaw has been released (the "Eligibility Date"), (iii) 50% of the Cash Bonus would be paid on the Eligibility Date, and the other 50% would be paid in ten equal monthly installments beginning one month following the Eligibility Date. Mr. Cross would be granted a stock option in an amount representing an aggregate 2.5% of the outstanding shares of Company common stock following the completion of the Company's recapitalization under the creditor and claimant liabilities restructuring. These options have a term of 10 years and vest 20% on the date of grant and 1/48th of the balance on the last day of each month for the next 48 months following the Eligibility Date.

NOTE 17 - CREDITOR AND CLAIMANT LIABILITIES RESTRUCTURING

On January 12, 2006, the Company issued a Stock Subscription Agreement & Mutual Release ("the Original Release") to each creditor and claimant ("Subscriber") of the Company for purposes of entering into a final and binding settlement with respect to any and all claims, liabilities, demands, causes of action, costs, expenses, attorneys fees, damages, indemnities, and obligations of every kind

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and nature that the creditor and/or claimant may have with the Company ("Subscriber Claims"). Under terms of this agreement, the Company sold to the Subscriber and the Subscriber purchased from the Company shares ("Stock") of its Series A-1 Preferred stock at a price of \$0.80 per share. The aggregate purchase price was equivalent to the value of the Subscriber Claims being settled through this settlement and release. Subscriber was deemed to have paid for the Stock through the settlement and release of Subscriber Claims. Each share of Stock was automatically convertible into 1/3 share of the Company's common stock upon the effectiveness of an amendment to the Company's certificate of incorporation which provided for a sufficient number of authorized but unissued and unreserved shares of the Company's common stock to permit the conversion of all issued and outstanding shares of Series A-1 Preferred. The Company issued the Series A-1 Preferred shares following the final determination of the claims and acceptance by the Company of each claimant submitted Stock Subscription Agreement and Mutual Release through countersignature thereof.

The Original Release also provided that in the event that (a) a bona fide sale or (series of related sales) by the Company of equity interests in the Company in an amount equal to or in excess of \$3,000,000 or (b) any merger, consolidation, recapitalization, reclassification, reincorporation, reorganization, share exchange, sale of all or substantially all of the assets of the Company or comparable transaction, was not consummated on or before March 31, 2006 (the "Termination Date"), the Stock Subscription Agreement & Mutual Release would terminate and be null and void, the Series A-1 Preferred issued to Subscriber would be cancelled and the Subscriber Claims would remain in full force and effect on their terms. Each Subscriber agreed not to transfer or sell any portion of the Stock until the next business day after the Termination Date, subject to (i) an effective registration under the Securities Act or in a transaction which is otherwise in compliance with the Securities Act, (ii) an effective registration under any applicable state securities statute or in a transaction otherwise in compliance with any applicable state securities statute, and (iii) evidence of compliance with the applicable securities laws of other jurisdictions. As described below, the Company completed the sale of \$4.8 million in equity securities under the Series A Preferred Financing on March 27, 2006 thereby eliminating the provision for automatic termination of this arrangement.

The following table provides a summary as of March 31, 2006 of all claims settled by category with the (gain) loss recognized on the settlement:

| Settlement Category | Series A-1 Stock Issued | Fair Value of Stock | Claim Amount | (Gain) |
|--|----------------------------|------------------------|-----------------|---------|
| General Creditors | 20,538,589 | \$ 12,022,994 | \$ 16,298,504 | \$ (4,2 |
| Stockholders under Accommodation Agreement | 3,000,000 | 2,400,000 | 2,400,000 | |
| Mr. Allin and the Allin Dynastic Trust ... | 2,500,000 | 1,500,000 | 1,317,089 | 1 |
| Other Claimants | 7,381,489 | 4,428,894 | 1,243,282 | \$ 3,1 |
| | ----- | ----- | ----- | ----- |
| | 33,420,078 | \$ 20,351,888 | \$ 21,258,875 | \$ (9 |
| | ----- | ----- | ----- | ----- |

The fair value of the Series A-1 shares issued in settlements reached prior to March 31, 2006 amounted to \$0.60 per share, based on a comparison of the features of these shares to similar shares sold in private placement transactions to unrelated parties for cash and the trading price of the Company's shares at the time of the settlements. These settlement agreements effectuated a complete settlement of these debts, claims and liabilities and the mutual release of the parties with respect thereto.

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The Company accounted for the extinguishment of liabilities payable to general creditors in accordance with SFAS 15 "Accounting by Debtors and Creditors for Troubled Debt Restructurings," due to the fact that the holders of these notes granted to Company concessions intended to alleviate its immediate liquidity constraints. These concessions

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that the creditors granted to the Company enabled it to (a) effectuate their settlement through an exchange of equity instead of a use of cash and (b) consummate a private placement of equity securities (Note 20) that resulted in an infusion of cash that was needed to sustain operations.

Claimants other than Mr. Allin and the Allin Dynastic Trust that participated in the settlement include certain parties that were previously engaged in litigation with the Company including the Sherleigh Associates Profit Sharing Plan to which the Company issued 2,312,500 shares for a settlement loss of \$1,387,500, Richard Linting to whom the Company issued 1,777,261 shares for a settlement loss of approximately \$773,000 and the holders of the Marie Graul claim to whom the Company issued 1,164,461 shares for a settlement loss of approximately \$698,000.

NOTE 18 - SERIES A AND SERIES A-1 PREFERRED STOCK

On March 1, 2006, the Company filed with the Delaware Secretary of State a Certificate of Designation of Preferences, Rights and Limitations of Series A Convertible Preferred Stock and Series A-1 Convertible Preferred Stock designating the rights, preferences and privileges of 2,160 shares of Series A Preferred stock and 50,000,000 shares of Series A-1 Preferred stock.

SERIES A PREFERRED STOCK

The Series A Preferred stock has a stated value of \$5,000 per share, has no maturity date, carries a dividend of 10% per annum, with such dividend accumulating on a cumulative basis and is payable only (i) at such time as declared payable by the Board of Directors of the Company or (ii) in the event of liquidation, as part of the liquidation preference amount ("Liquidation Preference Amount"). The Liquidation Preference Amount is equal to 125% of the sum of: (i) the stated value of any then unconverted shares of Series A Preferred stock and (ii) any accrued and unpaid dividends thereon. An event of liquidation means any liquidation, dissolution or winding up of the Company, whether voluntary or involuntary, as well as any change of control of the Company which includes the sale by the Company of either (x) substantially all its assets or (y) the portion of its assets which comprises its core business technology, products or services.

The Series A Preferred stock is convertible, at the option of the holder, into shares of the Company's common stock ("Conversion Shares") at an initial conversion price ("Initial Conversion Price") which shall be \$2.40 per share based on the stated value of the Series A Preferred stock, subject to adjustment for stock splits, dividends, recapitalizations, reclassifications, payments made to Common Stock holders and other similar events and for issuances of additional securities at prices more favorable than the conversion price at the date of such issuance.

The Series A Preferred stock is mandatorily convertible into shares of the Company's common stock at the Initial Conversion Price, which is subject to

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adjustment as described above, on the date that: (i) there shall be an effective registration statement covering the resale of the Conversion Shares, (ii) the average closing price of the Company's common stock, for a period of 20 consecutive trading days is at least 250% of the then applicable Conversion Price, and (iii) the average daily trading volume of the Company's common stock for the same period is at least 8,334 shares.

SERIES A-1 PREFERRED STOCK

The Series A-1 Preferred stock has a stated value of \$0.80 per share, has no maturity date, carries a non-cumulative dividend of 5% per annum, with such dividend payable only (i) at such time as declared payable by the Board of Directors of the Company or (ii) in the event of liquidation, as part of the liquidation preference amount ("Series A-1 Liquidation Preference Amount"). The Series A-1 Liquidation Preference Amount is equal to the sum of: (i) the stated value of any then unconverted shares of Series A-1 Preferred stock and (ii) any accrued and unpaid dividends thereon. An event of liquidation means any liquidation, dissolution or winding up of the Company, whether voluntary or involuntary, as well as any change of control of the Company which includes the sale by the Company of either (x) substantially all its assets or (y) the portion of its assets which comprises its core business technology, products or services.

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The Series A-1 Preferred stock is not convertible at the option of the holder. Each share of Series A-1 Preferred stock automatically converts into the Company's common stock, at a conversion price of \$2.40 per share based on the stated value of the Series A-1 Preferred stock, upon the effectiveness of an amendment to the Company's certificate of incorporation which provides for a sufficient number of authorized shares to permit the exercise or conversion of all issued and outstanding shares of Series A Preferred stock, Series A-1 Preferred stock and all options, warrants and other rights to acquire shares of the Company's common stock.

PRIVATE PLACEMENT OF SERIES A PREFERRED STOCK AND WARRANTS

In January 2006, the Company initiated a \$5,400,000 financing transaction (the "Series A Preferred Financing") which would, for each \$100,000 Unit purchased, result in the issuance of (i) 20 shares of Series A Preferred Stock and (ii) warrants ("Investor Warrants") to purchase 13,888.9 shares of the Company's common stock. The minimum amount of the Series A Preferred Financing is \$3,000,000 ("Minimum Amount") and the maximum amount is \$5,400,000. Apex agreed to purchase up to \$1,500,000 which will all be available to fund the Minimum Amount, provided however, in the event that the Series A Preferred Financing is over-subscribed as to the Minimum Amount, then for each \$1.00 of such over subscription up to \$250,000, the Apex funding commitment will be reduced on a dollar for dollar basis, down to a minimum amount of \$1,250,000. Additionally, holders of the 2006 Bridge Notes were mandatorily obligated to exchange their 2006 Bridge Notes for Units in the Series A Preferred Financing upon consummation of the Series A Preferred Financing at the face value of their 2006 Bridge Notes. The issuance of Units to the holders of 2006 Bridge Notes counts toward satisfying the Minimum Amount.

The Investor Warrants have a term of 5 years and an exercise price of \$3.00 per share. Each Investor Warrant will entitle the holder thereof to purchase 13,888.9 shares of the Company's common stock (the "Warrant Shares"), subject to anti-dilution provisions similar to those of the conversion rights of the Series A Preferred stock. The Company is obligated to include the Conversion Shares and

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the Warrant Shares in the Registration Statement which the Company has committed to file in connection with the creditor and claimant liabilities restructuring described above. The Conversion Shares and the Warrant Shares will also have piggyback registration rights.

In connection with the Series A Preferred Financing, the Company retained Laidlaw as its non-exclusive placement agent ("Series A Preferred Placement Agent"). Laidlaw shall receive, in its role as Series A Preferred Placement Agent, (i) a cash fee equal to 10% of all gross proceeds, excluding the Apex proceeds, delivered at each Closing and (ii) a warrant (the "Agent Warrants") to purchase the Company's common stock equal to 10% times the sum of (x) the Conversion Shares to be issued upon conversion of the shares of Series A Preferred stock issued at each Closing and (y) the number of shares of the Company's common stock reserved for issuance upon the exercise of the Investor Warrants issued at each closing. The Agent Warrants shall have a term of 5 years and an exercise price of \$3.00 per share. Additionally, the Company shall pay the Series A Preferred Placement Agent a non-accountable expense allowance of \$25,000. The Agent Warrants have a fair value of \$274,393. Assumptions relating to the estimated fair value of these warrants are as follows: fair value of common stock of \$0.80; risk-free interest rate of 4.52%; expected dividend yield zero percent; expected warrant life of five years; and current volatility of 125%.

On March 3, 2006, the investors in the Series A Preferred Financing agreed to a modification of the terms of this financing arrangement to waive the requirement for 100% completion of the creditor and claimant liabilities restructuring for release of the net proceeds of the Series A Preferred Financing in order to allow the Company to proceed with its business plan and to protect the investors in the Series A Preferred Financing. The modifications provide for the net proceeds of the Series A Preferred Financing to be deposited with an escrow agent whereby funds will be released to the Company to cover payroll, rent and other operating costs, including eligible payables not otherwise subject to the creditor and claimant liabilities restructuring, on a bi-monthly basis.

As of March 27, 2006, the Company consummated the Series A Preferred Financing with the closing of funds totaling \$4,465,501, resulting in the issuance of 893 shares of Series A Preferred Stock and 620,233 common stock purchase warrants to the purchasers of the Series A Preferred Stock. This amount is comprised on \$720,001 associated with the conversion of the Bridge Notes, \$895,000 provided by Apex and \$2,850,500 from parties made available by the Series A Preferred Placement Agent. The Company has also issued to Laidlaw 198,375 common stock purchase warrants, the Agent Warrants, to Laidlaw as Series A Preferred Placement Agent. The Investor Warrants have a fair value of \$857,908. Assumptions relating to the estimated fair value of these warrants are as follows: fair value of common stock of \$1.71; risk-free interest rate of 4.52%; expected dividend yield zero percent; expected warrant life of five years; and current volatility of 125%. The Company paid Laidlaw a Series A Placement Agent fee of \$339,051 which includes the \$54,000 placement agent fee associated with the 2006 Bridge Notes.

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In order to effect the availability of these funds to the Company prior to the completion of the creditor and claimant liabilities restructuring, the Company, on March 27, 2006, entered into a post-closing restricted cash escrow agreement ("Post-Closing Escrow Agreement") with an escrow agent ("Escrow Agent"). As of March 27, 2006, the Escrow Agent was provided \$2,183,026 in net offering proceeds. The escrow agent is holding the funds and making periodic disbursements to the Company on or after the 15th of each calendar month and on

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or after the last day of each calendar month. The Company is required to provide a detailed schedule of the mid-month, month-end and maximum monthly disbursement amounts to substantiate its request for a release of any funds. The Company cannot provide any assurance that it will be successful in its efforts to complete the creditor and claimant liabilities restructuring. Additionally there is no assurance that by securing this additional financing the Company will be successful in the implementation and execution of its business plan.

NOTE 19 - STOCKHOLDERS' EQUITY

ISSUANCE OF COMMON STOCK PURCHASE WARRANTS

On January 28, 2006 the Company issued warrants for 20,000 shares at a \$18.00 per share exercise price to Apex in connection with the Interim Bridge Financing III financing. The aggregate fair value of these warrants amounted to \$20,316.

On February 13, 2006 the Company issued warrants for 6,000 shares at a \$18.00 per share exercise price to Apex in connection with the Interim Bridge Financing III financing. The aggregate fair value of these warrants amounted to \$6,634.

On February 21, 2006 the Company issued warrants for 1,250 shares at a \$18.00 per share exercise price to Apex in connection with the Interim Bridge Financing III financing. The aggregate fair value of these warrants amounted to \$1,382.

On March 1, 2006 the Company issued warrants for 6,417 shares at a \$18.00 per share exercise price to Apex in connection with the Interim Bridge Financing III financing. The aggregate fair value of these warrants amounted to \$10,029.

On March 17, 2006 the Company issued warrants for 3,750 shares at a \$18.00 per share exercise price to Apex in connection with the Interim Bridge Financing III financing. The aggregate fair value of these warrants amounted to \$5,861.

On March 22, 2006 the Company issued warrants for 2,500 shares at a \$18.00 per share exercise price to Apex in connection with the Interim Bridge Financing III financing. The aggregate fair value of these warrants amounted to \$3,907.

On March 27, 2006 the Company issued warrants for 620,233 shares at a \$3.00 per share exercise price to the investors in the Series A Preferred Financing in connection with the Series A Preferred Financing. Additionally, the Company issued 198,375 common stock purchase warrants at a \$3.00 per share exercise price to Laidlaw as placement agent in the Series A Preferred Financing.

ISSUANCE OF EMPLOYEE STOCK OPTIONS

During the three months ended March 31, 2006, the Company issued stock options to employees to purchase 99,575 shares. These options include a grant to purchase 73,371 shares at \$1.65 per share, with a fair value of \$94,436, to the Chief Operating Officer of the Company, Mr. Braden Waverley, upon the signing of his employment agreement with the Company. Additionally, the Company granted options to purchase 26,204 shares at \$1.65 per share, with a fair value of \$33,727, to Mr. Martin T. Johnson, the Company's Chief Financial Officer, upon the signing of his employment agreement with the Company.

The fair value of the unvested portion of stock options issued prior to December 31, 2005 was \$776,251 as of December 31, 2005. Including the options granted in the three months ended March 31, 2006, the fair value of the unvested portion of

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stock option grants as of March 31, 2006 is \$731,080.

NOTE 20 - DISCONTINUED OPERATIONS

During the three months ended March 31, 2006, the Company made the decision to streamline the Company's business focus on enterprise level software and service solutions designed to help customers create, manage and apply complex rule sets that support business policies, enhance work flow processes, enforce regulatory compliance and reduce the time, cost and overhead of electronic message management. This decision resulted in the Company's decision to find a buyer for the LucidLine business. Based on this decision, the Company has recorded the assets net of liabilities as assets of discontinued operations on the Condensed Consolidated Balance Sheet as of March 31, 2006 and has recorded the loss on discontinued operations on the Condensed Consolidated Statement of Operations for the three months ended March 31, 2006 and March 31, 2005. Revenue associated with the discontinued operations was \$99,167 and \$42,430 for the three months ended March 31, 2006 and 2005, respectively. Loss on discontinued operations was \$104,962 and \$102,377 for the three months ended March 31, 2006 and 2005, respectively.

On April 18, 2006, the Company entered into a Stock Purchase Agreement with Walnut Valley, Inc. pursuant to which the Company sold all of the outstanding shares of LucidLine, Inc. (Note 21).

NOTE 21 - SUBSEQUENT EVENTS

ADDITIONAL SERIES A PREFERRED STOCK AND WARRANT SALE

On April 3, 2006, the Company received \$355,000 associated with the Series A Preferred Financing from Apex Investment Fund V, L.P. With receipt of these funds, the Company issued 71 shares of Series A Preferred Stock and 49,306 common stock purchase warrants. Receipt of these funds completes the funding of the Series A Preferred Financing.

SALE OF LUCIDLINE, INC.

On April 18, 2006, the Company entered into a Stock Purchase Agreement with Walnut Valley, Inc. pursuant to which the Company sold all of the outstanding shares of LucidLine, Inc., the Company's wholly-owned subsidiary, to Walnut Valley, Inc. in consideration for a cash payment of \$25,000 and the issuance of a Promissory Note in the principal amount of \$25,000 by Walnut Valley in favor to the Company. The sale of LucidLine is designed to streamline the Company's business focus on enterprise level software and service solutions designed to help customers create, manage and apply complex rule sets that support business policies, enhance work flow processes, enforce regulatory compliance and reduce the time, cost and overhead of electronic message management.

SETTLEMENT OF SHERLEIGH ASSOCIATES, INC. PROFIT SHARING PLAN LAWSUIT

On April 24, 2006, the Company entered into a Stock Subscription Agreement and Mutual Release with the Sherleigh Associates, Inc. Profit Sharing Plan ("Sherleigh"). This agreement provides for a final and binding settlement with respect to any and all claims, liabilities, demands, causes of action, costs, expenses, attorneys fees, damages, indemnities and obligations of any kind and nature in law, equity or otherwise, known and unknown, suspected and unsuspected, disclosed and undisclosed arising out of or in any way related to the business relationship between the parties that Sherleigh may have against the Company ("Sherleigh Claims").

In settlement of the Sherleigh Claims, Sherleigh purchased from the Company

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2,312,500 shares of the Series A-1 Preferred Stock for a purchase price of \$0.80 per share or \$1,850,000. The aggregate purchase price is equivalent to the value of the Sherleigh Claims being settled, which is being paid through the settlement and release of the Sherleigh Claims.

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On May 4, 2006, Patron became aware that Lok Technologies, Inc. had filed a complaint on or about March 30, 2006 against the Company, Entelagent Software Corp. and unnamed defendants in the Superior Court of California, County of Santa Clara alleging breach of contract, breach of duty of good faith and fair dealing and unjust enrichment and seeking damages, interest, disgorgement of any unjust enrichment, attorneys fees and cost. Prior to receipt of this notice of litigation, the Company had recorded a liability of \$320,000 plus accrued interest of \$159,432. The Company believes that it has defenses to these claims but has proposed to settle this litigation as part of the creditor and claimant liabilities restructuring. The Company cannot provide any assurance that the ultimate settlement of this claim will not have a material adverse affect on its financial condition.

FILING OF FORM 10-KSB FOR THE YEAR ENDED DECEMBER 31, 2006

On April 10, 2007, the Company filed its Form 10-KSB for the year ended December 31, 2006. The Form 10-KSB for the year ended December 31, 2006 should be referred to for additional subsequent events which have occurred between the original filing date (May 22, 2006) of the Form 10-QSB for the three months ended March 31, 2006 and the filing of the Form 10-KSB on April 10, 2007.

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

PATRON SYSTEMS, INC. AND SUBSIDIARIES

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS MARCH 31, 2006

The following discussion and analysis should be read in conjunction with the Annual Report on Form 10-KSB, including the consolidated financial statements, and the related notes thereto, for the year ended December 31, 2005 of Patron Systems, Inc. and subsidiaries (collectively referred to as "Patron," the "Company," "we," "us," or "our"). Except for historical information contained herein, the matters discussed below are forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Such statements involve risks and uncertainties, including, but not limited to, economic, governmental, political, competitive and technological factors affecting our operations, markets, products, prices and other factors discussed elsewhere in this report and other reports filed by us with the Securities and Exchange Commission ("SEC"). These factors may cause results to differ materially from the statements made in this report or otherwise made by or on our behalf.

OVERVIEW

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On February 25, 2005, we consummated the acquisitions of Complete Security Solutions, Inc. ("CSSI") and LucidLine, Inc. ("LucidLine") pursuant to the filings of Agreements and Plans of Merger with the Secretaries of State of the States of Delaware and Illinois, respectively. On February 28, 2005, we consummated a private placement with accredited investors in the amount of \$3.5 million. On March 30, 2005, we consummated the acquisition of Entelagent Software Corp. ("Entelagent") pursuant to the filing of an Agreement and Plan of Merger with the Secretary of State of the State of California. From March 31, 2005 to December 31, 2005, we borrowed \$3,300,000 from a stockholder, Apex Investment Fund V, LP. During the three months ended September 30, 2005 we raised approximately \$3,600,000 in additional gross funds in five capital financing transactions, which includes converting \$1,650,000 in advances from stockholders into Bridge Notes. Net proceeds from all of these transaction amounted to \$3,594,000, which were used principally to fund operations and repay certain liabilities. We discuss these transactions in further detail in this report. During the three months ended March 31, 2006, we raised \$4,285,501 of gross proceeds (\$3,946,450 net proceeds after the payment of certain transaction expenses) in the Series A Preferred Financing.

Our strategic mission is to solve a set of enterprise-level customer problems associated with electronic message management, whether in the form of e-mail, eforms or instant messaging. Our software and services solutions are designed to help our customers create, manage and apply complex rule sets that support business policies, enhance work flow processes, enforce regulatory compliance, and reduce the time, cost and overhead of message management. Our suite of products addresses e-mail policy management, e-mail retention policies, archiving and eDiscovery, proactive e-mail supervision, and the protection of messages and their attachments in motion and at rest. Our eforms solution enables customers to quickly and easily create forms, capture, share, and manage data in an industry standard format.

We currently offer software solutions that fit into overall corporate compliance and data protection initiatives by automatically finding, archiving and applying persistent protection to sensitive data - beyond authentication - whenever, wherever and however sensitive data is shared, accessed and stored. Additionally we offer software solutions that support real-time secure collection, delivery and sharing of field-based report information. This software allows law enforcement and public-safety agencies to have real-time access to field reporting data for use inside a department or in a multi-jurisdictional information sharing system.

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CRITICAL ACCOUNTING POLICIES

The preparation of our consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to exercise its judgment. We exercise considerable judgment with respect to establishing sound accounting polices and in making estimates and assumptions that affect the reported amounts of our assets and liabilities, our recognition of revenues and expenses, and disclosures of commitments and contingencies at the date of the financial statements.

On an ongoing basis, we evaluate our estimates and judgments. Areas in which we exercise significant judgment include, but are not necessarily limited to, our valuation of accounts receivable, recoverability of long-lived assets, income taxes, equity transactions (compensatory and financing) and contingencies. We have also adopted certain polices with respect to our recognition of revenue

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that we believe are consistent with the guidance provided under Securities and Exchange Commission Staff Accounting Bulletin No. 104 and estimate values of delivered and undelivered elements.

We base our estimates and judgments on a variety of factors including our historical experience, knowledge of our business and industry, current and expected economic conditions, the composition of our products, regulatory environment, and in certain cases, the results of outside appraisals. We constantly re-evaluate our estimates and assumptions with respect to these judgments and modify our approach when circumstances indicate that modifications are necessary.

While we believe that the factors we evaluate provide us with a meaningful basis for establishing and applying sound accounting policies, we cannot guarantee that the results will always be accurate. Since the determination of these estimates requires the exercise of judgment, actual results could differ from such estimates.

A description of significant accounting policies that require us to make estimates and assumptions in the preparation of our consolidated financial statements are as follows:

ACCOUNTS RECEIVABLE AND REVENUE RECOGNITION

We derive our revenues from the following sources: (1) sales of computer software, which includes new software licenses and software updates and product support revenues and (2) professional consulting services.

We apply the revenue recognition principles set forth under AICPA Statement of Position ("SOP") 97-2 "Software Revenue Recognition" and Securities and Exchange Commission Staff Accounting Bulletin ("SAB") 104 "Revenue Recognition" with respect to its revenue. Accordingly, we record revenue when (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred, (iii) the vendor's fee is fixed or determinable, and (iv) collectability is reasonably assured.

We also accrue unbilled revenue under software licenses and services delivered under contractual arrangements which provide for billings to be made at intervals that may differ from the periods of delivery or performance.

We generate revenues through sales of software licenses and annual support subscription agreements, which include access to technical support and software updates (if and when available). Software license revenues are generated from licensing the rights to use products directly to end-users and through third party service providers.

Revenues from software license agreements are generally recognized upon delivery of software to the customer. All of our software sales are supported by a written contract or other evidence of sale transaction such as a customer purchase order. These forms of evidence clearly indicate the selling price to the customer, shipping terms, payment terms (generally 30 days) and refund policy, if any. The selling prices of these products are fixed at the time the sale is consummated.

Revenue from post-contract customer support arrangements or undelivered elements are deferred and recognized at the time of delivery or over the period in which the services are performed based on vendor specific objective evidence of fair value for such undelivered elements. Vendor specific objective evidence is typically based on the price charged when an element is sold separately or, if an element is not sold separately, on the price established by an authorized

level of management, if it is probable that the price, once established, will not change before market introduction. We use the residual method prescribed in SOP 98-9, "Modification of SOP 97-2, Software Revenue Recognition With Respect to Certain Transaction" to allocate revenues to delivered elements once it has established vendor-specific objective evidence of fair value for such undelivered elements.

Professional consulting services are billed based on the number of hours of consultant services provided and the hourly billing rates. We recognize revenue under these arrangements as the service is performed.

We adjust our accounts receivable balances that we deem to be uncollectible. The allowance for doubtful accounts is our best estimate of the amount of probable credit losses in our existing accounts receivable. We review our allowance for doubtful accounts on a monthly basis to determine the allowance based on an analysis of its past due accounts. All past due balances that are over 90 days are reviewed individually for collectability. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. An allowance for doubtful accounts is not provided because in our opinion, all accounts recorded are deemed to be collectible.

INCOME TAXES

We are required to determine the aggregate amount of income tax expense or loss based upon tax statutes in jurisdictions in which we conduct business. In making these estimates, we adjust our results determined in accordance with generally accepted accounting principles for items that are treated differently by the applicable taxing authorities. Deferred tax assets and liabilities, as a result of these differences, are reflected on our balance sheet for temporary differences loss and credit carry forwards that will reverse in subsequent years. We also establish a valuation allowance against deferred tax assets when it is more likely than not that some or all of the deferred tax assets will not be realized. Valuation allowances are based, in part, on predictions that management must make as to our results in future periods. The outcome of events could differ over time which would require us to make changes in our valuation allowance.

GOODWILL AND INTANGIBLE ASSETS

We account for Goodwill and Intangible Assets in accordance with Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets." Under SFAS No. 142, goodwill and intangibles that are deemed to have indefinite lives are no longer amortized but, instead, are to be reviewed at least annually for impairment. Application of the goodwill impairment test requires judgment, including the identification of reporting units, assigning assets and liabilities to reporting units, assigning goodwill to reporting units, and determining the fair value. Significant judgments required to estimate the fair value of reporting units include estimating future cash flows, determining appropriate discount rates and other assumptions. Changes in these estimates and assumptions could materially affect the determination of fair value and/or goodwill impairment for each reporting unit. During the year ended December, 31, 2005 we recorded \$22,440,212 of goodwill in connection with the acquisitions of LucidLine, CSSI and Entelagent. In accordance with SFAS 142, we conducted our annual impairment review of goodwill for the year ended December 31, 2005, which resulted in a goodwill impairment charge of \$12,929,696 (Note 6). Intangible assets continue to be amortized over their estimated useful lives.

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We engaged an outside specialist to assist us with performing our annual goodwill impairment tests. These tests were made using a discounted cash flow model to value the business. This approach requires us to forecast our expectation of revenues and cash flows in future periods and to work with an independent specialist on developing assumptions relating to the risk that such cash flows may or may not materialize in future periods.

SHARE BASED PAYMENTS AND OTHER EQUITY TRANSACTIONS

Prior to January 1, 2006, we accounted for employee stock based compensation in accordance with Accounting Principles Board ("APB") Opinion No. 25 "Accounting for Stock Issued to Employees." We applied the proforma disclosure requirements of SFAS No. 123 "Accounting for Stock-Based Compensation."

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Effective January 1, 2006, we adopted SFAS No. 123R "Share Based Payment." This statement is a revision of SFAS Statement No. 123, and supersedes APB Opinion No. 25, and its related implementation guidance. SFAS 123R addresses all forms of share based payment ("SBP") awards including shares issued under employee stock purchase plans, stock options, restricted stock and stock appreciation rights. Under SFAS 123R, SBP awards result in a cost that is measured at fair value on the awards' grant date, based on the estimated number of awards that are expected to vest. We adopted the modified prospective method with respect to accounting for our transition to SFAS 123(R) and measured unrecognized compensation cost. Under this method of accounting, we are required to estimate the fair value of share based payments that we make to our employees by developing assumptions regarding expected holding terms of stock options, volatility rates and expectation of forfeitures and future vesting that can significantly impact the amount of compensation cost that we recognize in each reporting period.

We are also required to apply complex accounting principles with respect to accounting for financing transactions that we have consummated in order to sustain our business. These transactions, which generally consist of convertible debt and equity instruments, require us to use significant judgment in order to assess the fair values of these instruments at their dates of issuance, which is critical to making a reasonable presentation of our financing costs and how we finance our business.

Formulating estimates in any of the above areas requires us to exercise significant judgment. It is at least reasonably possible that the estimates of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements that we considered in formulating our estimates could change in the near term due to one or more future confirming events. Accordingly, the actual results regarding estimates of any of the above items as they are presented in the financial statements could differ materially from our estimates.

RESULTS OF OPERATIONS

THREE MONTHS ENDED MARCH 31, 2006 COMPARED TO THE THREE MONTHS ENDED MARCH 31, 2005.

For the three months ended March 31, 2006, our consolidated revenues amounted to \$261,785 compared to \$6,430 for the three months ended March 31, 2005. The increase is the result of business combinations that we consummated with CSSI in

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February 2005 and Entelagent in March 2005.

Cost of Sales for the three months ended March 31, 2006 amounted to \$57,419 compared to \$21,233 for the three months ended March 31, 2005. Cost of sales during the three months ended March 31, 2006 and March 31, 2005 includes \$27,522 and \$19,230, respectively, associated with the amortization of developed technology that we acquired from CSSI and Entelagent.

Operating expenses amounted to \$1,118,826 for the three months ended March 31, 2006 as compared to \$1,610,877 for the three months ended March 31, 2005, a decrease of \$492,051. The decrease in operating expenses includes an increase of approximately \$466,000 for salaries associated with an increase in the number of employees from acquired businesses, an increase of approximately \$517,000 for legal and professional fees that we incurred principally in connection with the year-end financial audit, the negotiation and settlement of various legal matters under the creditor and claimant liabilities restructuring program and the implementation of the Series A Preferred Financing, an increase of approximately \$23,000 for amortization of acquired intangible assets, an increase of approximately \$173,000 associated with the expensing of stock options, an increase of approximately \$3,000 associated with a stock-based penalty under a collateralized financing arrangement and an increase approximately \$65,000 for increased general and administrative expenses associated with the acquired businesses. These increases were offset by a gain of approximately \$907,000 associated with the settlement of outstanding liabilities, claims and litigation under the creditor and claimant liabilities restructuring, an approximately \$464,000 reduction in expense associated with the amortization of stock-based compensation arrangements and approximately \$369,000 reduction in expense associated with a penalty provision of an Accommodation Agreement.

Our consolidated loss from operations for the three months ended March 31, 2006 amounted to \$914,460 compared to a loss of \$1,625,680 for the same period in 2005. Our loss was reduced as a result of the increases in operating expenses offset by the gain on the settlement of the creditor and claimant liabilities restructuring discussed above.

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Interest expense during the three months ended March 31, 2006 amounted to \$972,464 as compared to \$494,998 for the three months ended March 31, 2005. The increase is directly related to our issuance of Series A Preferred stock, issuances of notes and the increased borrowings that we made to fund our working capital needs and to finance our acquisitions of CSSI, LucidLine and Entelagent. Non-cash interest relating to the amortization of deferred financing costs and the accretion of debt discounts during the three months ended March 31, 2006 amounted to approximately \$303,038 compared to \$414,485 in same period in 2005. The intrinsic value of the conversion option for bridge note holders, which has been classified as interest expense amounted to \$192,000 for the three months ended March 31, 2006 compared to \$0 in the same period in 2005. Amortization of deferred finance charges which have been classified as interest expense was approximately \$282,129 in the three months ended March 31, 2006 compared to \$153,520 in the same period in 2005. Accretion of debt discounts during the three months ended March 31, 2006 were approximately \$20,909 compared to \$260,965 in the same period in 2005. Interest income, was \$0 and \$19,250 in the three months ended March 31, 2006 and 2005, respectively. Interest income represents the interest earned from loans that we made to Entelagent prior to our acquisition of that business on March 30, 2005.

For the three months ended March 31, 2006, the net loss was \$1,991,824 or

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\$(0.96) per share on 2,083,954 weighted average common shares outstanding compared to a net loss of \$2,203,795 or \$(1.30) per share on 1,689,558 weighted average common shares outstanding for the three months ended March 31, 2005.

LIQUIDITY AND CAPITAL RESOURCES

We incurred a net loss of \$1,991,824 for the three months ended March 31, 2006, which includes \$797,921 of non-cash charges associated with the fair value of common stock we issued as penalties under certain registration rights agreements (\$2,852), fair value of a conversion option in connection with bridge note holders (\$192,000), accretion related to warrants issued in conjunction with notes payable (\$20,909), amortization of deferred financing costs (\$282,129), non-cash increase in interest payable to a former stockholder (\$48,400), depreciation and amortization (\$70,796), and a charge for stock based compensation (\$180,835). These non-cash charges were offset by a non-cash gain on issuance of preferred stock in settlement of debt totaling \$906,987. We also used \$957,122 of our restricted cash escrowed to settle liabilities assumed. Including the amounts above, we used net cash flows in our operating activities of \$3,454,807 during the three months ended March 31, 2006. Our working capital deficiency at March 31, 2006 amounts to \$5,659,898 and we are continuing to experience shortages in working capital. We are involved in litigation and are being investigated by the Securities and Exchange Commission with respect to certain of our press releases and our use of form S-8 to register shares of common stock that we issued to certain consultants in prior periods. We cannot provide any assurance that the outcome of these matters will not have a material adverse effect on our ability to sustain the business. These matters raise substantial doubt about our ability to continue as a going concern.

We expect to continue incurring losses for the foreseeable future due to the inherent uncertainty that is related to establishing the commercial feasibility of technological products and developing a presence in new markets. The Company's ability to successfully integrate the acquired businesses is critical to the realization of its business plan. We raised \$4,285,501 of gross proceeds (\$3,946,451 net proceeds after the payment of certain transaction expenses) in financing transactions during the three months ended March 31, 2006. We used \$3,454,807 of these proceeds to fund its operations and a net of \$225,228 in investing activities, principally for the purchase and development of software technology. Additionally, we made \$125,000 in legal payments associated with the settlement of accommodation agreements and incurred \$54,000 in deferred financing costs. Subsequent to March 31, 2006 we raised approximately \$355,000 in additional gross funds in the Series A Preferred Financing (Note 18).

We are currently in the process of attempting to raise additional capital and have taken certain steps to conserve our liquidity while we continue to integrate the acquired businesses. Although we believe that we have access to capital resources, we have not secured any commitments for additional financing at this time nor can we provide any assurance that we will be successful in our efforts to raise additional capital and/or successfully execute our business plan. In an effort to secure additional financing, we have offered our creditors and claimants an agreement to issue common stock for amounts owed to the holders of our indebtedness (including lenders, past-due trade accounts, and employees, consultants and other service providers with claims for fees, wages or expenses) (Note 17).

OFF-BALANCE SHEET ARRANGEMENTS

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At March 31, 2006, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance, variable interest or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As such, we are not exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships.

CAUTIONARY STATEMENTS AND RISK FACTORS

The risks noted below and elsewhere in this report and in other documents we file with the SEC are risks and uncertainties that could cause our actual results to differ materially from the results contemplated by the forward-looking statements contained in this report and other public statements we make.

RISKS RELATED TO OUR COMMON STOCK

THERE IS SUBSTANTIAL DOUBT ABOUT OUR ABILITY TO CONTINUE AS A GOING CONCERN.

We currently have a number of obligations that we are unable to meet without generating additional revenues or raising additional capital. We are also subject to substantial litigation and an investigation by the SEC described elsewhere herein. If we cannot generate additional revenues or raise additional capital in the near future, we may become insolvent. As of March 31, 2006, our cash balance was \$141,430 and we had a working capital deficit of \$5,659,898. This raises substantial doubt about our ability to continue as a going concern. Historically, we have funded our capital requirements with debt and equity financing. Our ability to obtain additional equity or debt financing depends on a number of factors including our financial performance and the overall conditions in our industry. If we are not able to raise additional financing or if such financing is not available on acceptable terms, we may liquidate assets, seek or be forced into bankruptcy, and/or continue operations but suffer material harm to our operations and financial condition. These measures could have a material adverse affect on our ability to continue as a going concern.

We are attempting to restructure any and all claims, liabilities, demands, causes of action, costs, expenses, attorneys' fees, damages, indemnities, and obligations of every kind and nature that certain creditors and claimants may have with us pursuant to the creditor and claimant liabilities restructuring described in Note 17. Our failure to successfully complete the creditor and claimant liabilities restructuring could adversely impact our ability to raise additional financing, or could force us to liquidate assets, or seek bankruptcy protection. There can be no assurance that we will successfully complete the creditor and claimant liabilities restructuring. Such a failure could materially adversely affect our ability to continue as a going concern.

INVESTORS MAY NOT BE ABLE TO ADEQUATELY EVALUATE OUR BUSINESS AND PROSPECTS DUE TO OUR LIMITED OPERATING HISTORY, LACK OF REVENUES AND LACK OF PRODUCT OFFERINGS.

We are at an early stage of executing our business plan and have no history of offering information security capabilities. We were incorporated in Delaware in 2002. Significant business operations only began with the acquisitions completed in February and March 2005. As a result of our limited history, it may be difficult to plan operating expenses or forecast our revenues accurately. Our assumptions about customer or network requirements may be wrong. The revenue and income potential of these products is unproven, and the markets addressed by these products are volatile. If such products are not successful, our actual operating results could be below our expectations and the expectations of investors and market analysts, which would likely cause the price of our common stock to decline.

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We generated no revenue from operations before December 31, 2004 and only limited revenues in the year ended December 31, 2005. We have relied on financing generated from our capital raising activities to fund the implementation of our business plan. We have incurred operating and net losses and negative cash flows from operations since our inception. As of March 31, 2006, we had an accumulated deficit of approximately \$86.4 million. We may continue to incur operating and net losses, due in part to implementing our acquisitions strategy, engaging in financing activities and expansion of our

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personnel and our business development capabilities. We will continue to seek financing for the acquisition of other acquisition targets that we may identify in the future. We continue to believe that we will secure financing in the near future, but there can be no assurance of our success. If we are unable to obtain the necessary funding, it will materially adversely affect our ability to execute our business plan and to continue our operations.

In addition, we may not be able to achieve or maintain profitability, and, even if we do achieve profitability, the level of any profitability cannot be predicted and may vary significantly from quarter to quarter.

THERE CAN BE NO GUARANTY THAT A MARKET WILL DEVELOP FOR THE PRODUCTS WE INTEND TO OFFER.

We currently have a limited offering of products. We intend to acquire products through the acquisition of existing businesses. There is no guarantee, however, that a market will develop for Internet security solutions of the type we intend to offer. We cannot predict the size of the market for Internet security solutions, the rate at which the market will grow, or whether our target customers will accept our acquired products.

OUR OPERATING RESULTS MAY FLUCTUATE SIGNIFICANTLY, WHICH MAY RESULT IN VOLATILITY OR HAVE AN ADVERSE EFFECT ON THE MARKET PRICE OF OUR COMMON STOCK.

The market prices of the securities of technology-related companies have historically been volatile and may continue to be volatile. Thus, the market price of our common stock is likely to be subject to wide fluctuations. If our revenues do not grow or grow more slowly than we anticipate, if operating or capital expenditures exceed our expectations and cannot be reduced appropriately, or if some other event adversely affects us, the market price of our common stock could decline. Only a small public market currently exists for our common stock and the number of shares eligible for sale in the public market is currently very limited, but is expected to increase. Sales of substantial shares in the future would depress the price of our common stock. In addition, we currently do not receive any stock market research coverage by any recognized stock market research or trading firm and our shares are not traded on any national securities exchange. A larger and more active market for our common stock may not develop.

Because of our limited operations history and lack of assets and revenues to date, our common stock is believed to be currently trading on speculation that we will be successful in implementing our acquisition and growth strategies. There can be no assurance that such success will be achieved. The failure to implement our acquisitions and growth strategies would likely adversely affect the market price of our common stock. In addition, if the market for technology-related stocks or the stock market in general experiences a continued or greater loss in investor confidence or otherwise fails, the market price of

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our common stock could decline for reasons unrelated to our business, results of operations and financial condition. The market price of our common stock also might decline in reaction to events that affect other companies in our industry even if these events do not directly affect us. General political or economic conditions, such as an outbreak of war, a recession or interest rate or currency rate fluctuations, could also cause the market price of our common stock to decline. Our common stock has experienced, and is likely to continue to experience, these fluctuations in price, regardless of our performance.

WE ARE CURRENTLY SUBJECT TO AN SEC INVESTIGATION WHICH COULD LEAD TO THE IMPOSITION OF SIGNIFICANT CIVIL PENALTIES AND COULD ADVERSELY AFFECT OUR ABILITY TO SELL OUR SECURITIES AND/OR HAVE OUR SECURITIES REGISTERED WITH THE SEC AND/OR VARIOUS STATES IF THE SEC BRINGS AN ACTION AGAINST US.

Pursuant to Section 20(a) of the Securities Act and Section 21(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), the staff of the SEC (the "Staff"), issued an order (In the Matter of Patron Systems, Inc. - Order Directing a Private Investigation and Designating Officers to Take Testimony (C-03739-A, February 12, 2004)) (the "Order") that a private investigation (the "SEC Investigation") be made to determine whether certain of our actions and certain of the actions of our officers and directors and others (as described below) violated Section 5(a) and 5(c) of the Securities Act and/or Section 10 and Rule 10b-5 promulgated under the Exchange Act. Generally, the Order provides, among other things, that the Staff is investigating (i) the legality of two (2) separate Registration Statements filed by us on Form S-8, filed on December 20, 2002 and on April 2, 2003, as amended on

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April 9, 2003 (collectively, the "Registration Statements"), covering the resale of, in the aggregate, 145,834 shares of common stock issued to various of our consultants, and (ii) whether in connection with the purchase or sale of shares of common stock, certain of our officers, directors and others (a) sold common stock in violation of Section 5 of the Securities Act and/or, (b) made misrepresentations and/or omissions of material facts and/or employed fraudulent devices in connection with such purchases and/or sales relating to certain of our press releases regarding, among other items, proposed mergers and acquisitions that were never consummated. If the SEC brings an action against us, it could result in, among other items, a civil injunctive order or an administrative cease-and-desist order being entered against us, in addition to the imposition of a significant civil penalty. Moreover, the SEC Investigation and/or a subsequent SEC action could affect adversely our ability to have our common stock listed on a stock exchange and/or quoted on The OTC Bulletin Board or NASDAQ, our ability to sell our securities and/or have our securities registered with the SEC and/or in various states and/or our ability to implement our business plan. To date, our legal counsel representing us in such matters has indicated that the SEC Investigation is ongoing and the Staff has not indicated whether it will or will not recommend that the SEC bring an enforcement action against us, our officers, directors and/or others.

THE CONCENTRATION OF OUR CAPITAL STOCK OWNERSHIP WITH INSIDERS IS LIKELY TO LIMIT THE ABILITY OF OTHER STOCKHOLDERS TO INFLUENCE CORPORATE MATTERS.

As of May 11, 2006, the executive officers, directors and entities affiliated with any of them together beneficially owned approximately 16.7% of our outstanding common stock. As a result, these stockholders may be able to exercise control over matters requiring approval by our stockholders, including the election of directors and approval of significant corporate transactions. This concentration of ownership might also have the effect of delaying or

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preventing a change in our control that might be viewed as beneficial by other stockholders.

FUTURE SALES OF SHARES BY EXISTING STOCKHOLDERS COULD CAUSE OUR STOCK PRICE TO DECLINE.

If our existing or future stockholders sell, or are perceived to sell, substantial amounts of our common stock in the public market, the market price of our common stock could decline. As of May 11, 2006, there were 1,879,946 shares of common stock outstanding, of which 314,498 shares were held by directors, executive officers and other affiliates, the sale of which are subject to volume limitations under Rule 144, various vesting agreements and our quarterly and other "blackout" periods. Furthermore, shares subject to outstanding options and warrants and shares reserved for future issuance under our stock option plan will become eligible for sale in the public market to the extent permitted by the provisions of various vesting agreements, the lock-up arrangements and Rule 144 under the Securities Act.

THE UNPREDICTABILITY OF AN ACQUIRED COMPANY'S QUARTERLY RESULTS MAY CAUSE THE TRADING PRICE OF OUR COMMON STOCK TO DECLINE.

The quarterly revenues and operating results of companies we may acquire will likely continue to vary in the future due to a number of factors, many of which are outside of our control. Any of these factors could cause the price of our common stock to decline. The primary factors that may affect future revenues and future operating results include the following:

- o the demand for our subsidiaries' current product offerings and our future products;
- o the length of sales cycles;
- o the timing of recognizing revenues;
- o new product introductions by us or our competitors;
- o changes in our pricing policies or the pricing policies of our competitors;
- o variations in sales channels, product costs or mix of products sold;
- o our ability to develop, introduce and ship in a timely manner new products and product enhancements that meet customer requirements;
- o our ability to obtain sufficient supplies of sole or limited source components for our products;
- o variations in the prices of the components we purchase;

- o our ability to attain and maintain production volumes and quality levels for our products at reasonable prices at our third-party manufacturers;
- o our ability to manage our customer base and credit risk and to collect our accounts receivable; and

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- o the financial strength of our value-added resellers and distributors.

Our operating expenses are largely based on anticipated revenues and a high percentage of our expenses are, and will continue to be, fixed in the short term. As a result, lower than anticipated revenues for any reason could cause significant variations in our operating results from quarter to quarter and, because of our rapidly growing operating expenses, could result in substantial operating losses.

OUR COMMON STOCK IS SUBJECT TO THE SEC'S PENNY STOCK RULES. THEREFORE, BROKER-DEALERS MAY EXPERIENCE DIFFICULTY IN COMPLETING CUSTOMER TRANSACTIONS AND TRADING ACTIVITY IN OUR SECURITIES MAY BE ADVERSELY AFFECTED.

If at any time a company has net tangible assets of \$5,000,000 or less and the common stock has a market price per share of less than \$5.00, transactions in the common stock may be subject to the "penny stock" rules promulgated under the Exchange Act. Under these rules, broker-dealers who recommend such securities to persons other than institutional accredited investors must:

- o make a special written suitability determination for the purchaser;
- o receive the purchaser's written agreement to a transaction prior to sale;
- o provide the purchaser with risk disclosure documents which identify certain risks associated with investing in "penny stocks" and which describe the market for these "penny stocks" as well as a purchaser's legal remedies; and
- o obtain a signed and dated acknowledgment from the purchaser demonstrating that the purchaser has actually received the required risk disclosure document before a transaction in a "penny stock" can be completed.

If our common stock becomes subject to these rules, broker-dealers may find it difficult to effectuate customer transactions and trading activity in our securities may be adversely affected. As a result, the market price of our securities may be depressed, and stockholders may find it more difficult to sell their shares of our common stock.

RISKS RELATED TO OUR BUSINESS

WE MAY BE UNABLE TO SUCCESSFULLY INTEGRATE ACQUIRED BUSINESSES.

Our business plan is dependent upon the acquisition and integration of companies that have previously operated independently. To date we have experienced delays in implementing our business plan as a result of limited capital resources, which have had a material adverse effect on our business. Further delays in the process of integrating could cause an interruption of, or loss of momentum in, the activities of our business and the loss of key personnel. The diversion of management's attention and any delays or difficulties encountered in connection with our integration of acquired operations could have an adverse effect on our business, results of operations, financial condition or prospects.

WE CURRENTLY DO NOT HAVE SUFFICIENT REVENUES TO SUPPORT OUR BUSINESS ACTIVITIES AND IF OPERATING LOSSES CONTINUE, WILL BE REQUIRED TO OBTAIN ADDITIONAL CAPITAL THROUGH FINANCINGS WHICH WE MAY NOT BE ABLE TO SECURE.

To achieve our intended growth, we will require substantial additional capital.

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We have encountered difficulty and delays in raising capital to date and the market environment for development stage companies, like ours, remains particularly challenging. There can be no assurance that funds will be available when needed or on acceptable terms. Technology companies in general have experienced difficulty in recent years in accessing capital. Our inability to obtain additional financing may require us to delay, scale back or eliminate certain of our growth plans which could have a material and adverse effect on our business, financial condition or results of operations or could cause us to cease operations. Even if we are able to obtain additional financing, such financing could be structured as equity financing that would dilute the ownership percentage of any investor in our securities.

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DOWNTURNS IN THE INTERNET INFRASTRUCTURE, NETWORK SECURITY AND RELATED MARKETS MAY DECREASE OUR REVENUES AND MARGINS.

The market for our current products and other products we intend to offer depends on economic conditions affecting the broader Internet infrastructure, network security and related markets. Downturns in these markets may cause enterprises and carriers to delay or cancel security projects, reduce their overall or security-specific information technology budgets or reduce or cancel orders for our current products and other products we intend to offer. In this environment, customers such as distributors, value-added resellers and carriers may experience financial difficulty, cease operations and fail to budget or reduce budgets for the purchase of our current products or other products we intend to offer. This, in turn, may lead to longer sales cycles, delays in purchase decisions, payment and collection, and may also result in price pressures, causing us to realize lower revenues, gross margins and operating margins. In addition, general economic uncertainty caused by potential hostilities involving the United States, terrorist activities, the decline in specific markets such as the service provider market in the United States, and the general decline in capital spending in the information technology sector make it difficult to predict changes in the purchase and network requirements of our potential customers and the markets we intend to serve. We believe that, in light of these events, some businesses may curtail or eliminate capital spending on information technology. A decline in capital spending in the markets we intend to serve may adversely affect our future revenues, gross margins and operating margins and make it necessary for us to gain significant market share from our future competitors in order to achieve our financial goals and achieve profitability.

COMPETITION MAY DECREASE OUR PROJECTED REVENUES, MARKET SHARE AND MARGINS.

The market for network security products is highly competitive, and we expect competition to intensify in the future. Competitors may gain market share and introduce new competitive products for the same markets and customers we intend to serve with our products. These products may have better performance, lower prices and broader acceptance than the products we currently offer or intend to offer.

Many of our potential competitors have longer operating histories, greater name recognition, large customer bases and significantly greater financial, technical, sales, marketing and other resources than we have. In addition, some of our potential competitors currently combine their products with other companies' networking and security products. These potential competitors also often combine their sales and marketing efforts. Such activities may result in reduced prices, lower gross and operating margins and longer sales cycles for the products we currently offer and intend to offer. If any of our larger

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potential competitors were to commit greater technical, sales, marketing and other resources to the markets we intend to serve, or reduce prices for their products over a sustained period of time, our ability to successfully sell the products we intend to offer, increase revenue or meet our or market analysts expectations could be adversely affected.

FAILURE TO ADDRESS EVOLVING STANDARDS IN THE NETWORK SECURITY INDUSTRY AND SUCCESSFULLY DEVELOP AND INTRODUCE NEW PRODUCTS OR PRODUCT ENHANCEMENTS WOULD CAUSE OUR REVENUES TO DECLINE.

The market for network security products is characterized by rapid technological change, frequent new product introductions, changes in customer requirements and evolving industry standards. We expect to introduce our products and enhancements to existing products to address current and evolving customer requirements and broader networking trends and vulnerabilities. We also expect to develop products with strategic partners and incorporate third-party advanced security capabilities into our intended product offerings. Some of these products and enhancements may require us to develop new hardware architectures that involve complex and time consuming processes. In developing and introducing our intended product offerings, we have made, and will continue to make, assumptions with respect to which features, security standards and performance criteria will be required by our potential customers. If we implement features, security standards and performance criteria that are different from those required by our potential customers, market acceptance of our intended product offerings may be significantly reduced or delayed, which would harm our ability to penetrate existing or new markets.

Furthermore, we may not be able to develop new products or product enhancements in a timely manner, or at all. Any failure to develop or introduce these new products and product enhancements might cause our existing products

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to be less competitive, may adversely affect our ability to sell solutions to address large customer deployments and, as a consequence, our revenues may be adversely affected. In addition, the introduction of products embodying new technologies could render existing products we intend to offer obsolete, which would have a direct, adverse effect on our market share and revenues. Any failure of our future products or product enhancements to achieve market acceptance could cause our revenues to decline and our operating results to be below our expectations and the expectations of investors and market analysts, which would likely cause the price of our common stock to decline.

WE HAVE EXPERIENCED ISSUES WITH OUR FINANCIAL SYSTEMS, CONTROLS AND OPERATIONS THAT COULD HARM OUR FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

Our ability to sell our intended product offerings and implement our business plan successfully in a volatile and growing market requires effective management and financial systems and a system of financial processes and controls. Through the quarter ended December 31, 2005, our Chief Executive Officer and Acting Chief Financial Officer evaluated the effectiveness of our disclosure controls and procedures in accordance with Exchange Act Rules 13a-15 or 15d-15 and identified material weakness in our internal controls. These material weaknesses affected our ability to timely file our reports with the SEC and communicate critical information to management that was needed to make business decisions. Although we have taken steps to correct these previous deficiencies and are currently in compliance with the SEC's reporting requirements, we have limited capital resources and are still at risk for the loss of key personnel in our finance department. The loss of key personnel in our finance department, or any

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other conditions that could disrupt our operations in this area, could have a material adverse affect on our ability to communicate critical information to management and our investors, raise capital and/or maintain compliance with our SEC reporting obligations. These circumstances, if they arise, could have a material adverse affect on our business.

We have limited management resources to date and are still establishing our management and financial systems. Growth, to the extent it occurs, is likely to place a considerable strain on our management resources, systems, processes and controls. To address these issues, we will need to continue to improve our financial and managerial controls, reporting systems and procedures, and will need to continue to expand, train and manage our work force worldwide. If we are unable to maintain an adequate level of financial processes and controls, we may not be able to accurately report our financial performance on a timely basis and our business and stock price would be harmed.

WE MAY NOT BE ABLE TO IMPLEMENT SECTION 404 OF THE SARBANES-OXLEY ACT ON A TIMELY BASIS.

The SEC, as directed by Section 404 of the Sarbanes-Oxley Act of 2002, adopted rules generally requiring each public company to include a report of management on the company's internal controls over financial reporting in its annual report on Form 10-KSB that contains an assessment by management of the effectiveness of the company's internal controls over financial reporting beginning in the year ended December 31, 2007. In addition, the company's independent registered accounting firm must attest to and report on management's assessment of the effectiveness of the company's internal controls over financial reporting. This requirement will first apply to our annual report on Form 10-KSB for the fiscal year ending December 31, 2008. We have not yet developed a Section 404 implementation plan. We have in the past discovered, and may in the future discover, areas of our internal controls that need improvement. How companies should be implementing these new requirements including internal control reforms to comply with Section 404's requirements and how independent auditors will apply these requirements and test companies' internal controls, is still reasonably uncertain. We expect that we may need to hire and/or engage additional personnel and incur incremental costs in order to complete the work required by Section 404. We can not guarantee that we will be able to complete a Section 404 plan on a timely basis. Additionally, upon completion of a Section 404 plan, we may not be able to conclude that our internal controls are effective, or in the event that we conclude that our internal controls are effective, our independent accountants may disagree with our assessment and may issue a report that is qualified. Any failure to implement required new or improved controls, or difficulties encountered in their implementation, could negatively affect our operating results or cause us to fail to meet our reporting obligations.

IF OUR FUTURE PRODUCTS DO NOT INTEROPERATE WITH OUR END CUSTOMERS' NETWORKS, INSTALLATIONS WOULD BE DELAYED OR CANCELLED, WHICH COULD SIGNIFICANTLY REDUCE OUR ANTICIPATED REVENUES.

Future products will be designed to interface with our end customers' existing networks, each of which have different specifications and utilize multiple protocol standards. Many end customers' networks contain multiple generations of products that have been added over time as these networks have grown and evolved. Our future products must interoperate with all of the products within these networks as well as with future products that might be added to these networks in order to meet end customers' requirements. If we find errors in the

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existing software used in our end customers' networks, we may elect to modify our software to fix or overcome these errors so that our products will interoperate and scale with their existing software and hardware. If our future products do not interoperate with those within our end customers' networks, installations could be delayed or orders for our products could be cancelled, which could significantly reduce our anticipated revenues.

AS A PUBLIC COMPANY, WE MAY INCUR INCREASED COSTS AS A RESULT OF RECENTLY ENACTED AND PROPOSED CHANGES IN LAWS AND REGULATIONS RELATING TO CORPORATE GOVERNANCE MATTERS AND PUBLIC DISCLOSURE.

Recently enacted and proposed changes in the laws and regulations affecting public companies, including the provisions of the Sarbanes-Oxley Act of 2002 and rules adopted or proposed by the SEC will result in increased costs for us as we evaluate the implications of these laws, regulations and standards and respond to their requirements. In addition, we will become subject to the internal control reporting requirement specified in Section 404 of the Sarbanes-Oxley Act of 2002 beginning in the year ended December 31, 2007, which will require us to expend substantial financial resources in order to become compliant with these requirements. These laws and regulations could make it more difficult or more costly for us to obtain certain types of insurance, including director and officer liability insurance, and we may be forced to accept reduced policy limits and coverage or incur substantially higher costs to obtain the same or similar coverage. The impact of these events could also make it more difficult for us to attract and retain qualified persons to serve on our board of directors, board committees or as executive officers. We cannot estimate the amount or timing of additional costs we may incur as a result of these laws and regulations.

WE DEPEND ON OUR KEY PERSONNEL TO MANAGE OUR BUSINESS EFFECTIVELY IN A RAPIDLY CHANGING MARKET, AND IF WE ARE UNABLE TO HIRE ADDITIONAL PERSONNEL OR RETAIN EXISTING PERSONNEL, OUR ABILITY TO EXECUTE OUR BUSINESS STRATEGY WOULD BE IMPAIRED.

Our future success depends upon the continued services of our executive officers. The loss of the services of any of our key employees, the inability to attract or retain qualified personnel in the future, or delays in hiring required personnel, could delay the development and introduction of, and negatively impact our ability to sell, our intended product offerings.

WE MIGHT HAVE TO DEFEND LAWSUITS OR PAY DAMAGES IN CONNECTION WITH ANY ALLEGED OR ACTUAL FAILURE OF OUR PRODUCTS AND SERVICES.

Because our intended product offerings and services provide and monitor network security and may protect valuable information, we could face claims for product liability, tort or breach of warranty. Anyone who circumvents our security measures could misappropriate the confidential information or other property of end customers using our products, or interrupt their operations. If that happens, affected end customers or others may sue us. Defending a lawsuit, regardless of its merit, could be costly and could divert management attention. Our business liability insurance coverage may be inadequate or future coverage may be unavailable on acceptable terms or at all.

WE COULD BECOME SUBJECT TO LITIGATION REGARDING INTELLECTUAL PROPERTY RIGHTS THAT COULD BE COSTLY AND RESULT IN THE LOSS OF SIGNIFICANT RIGHTS.

In recent years, there has been significant litigation in the United States involving patents and other intellectual property rights. We may become a party to litigation in the future to protect our intellectual property or as a result of an alleged infringement of another party's intellectual property. Claims for alleged infringement and any resulting lawsuit, if successful, could subject us to significant liability for damages and invalidation of our proprietary rights.

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These lawsuits, regardless of their success, would likely be time-consuming and

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expensive to resolve and would divert management time and attention. Any potential intellectual property litigation could also force us to do one or more of the following:

- o stop or delay selling, incorporating or using products that use the challenged intellectual property; and/or
- o obtain from the owner of the infringed intellectual property right a license to sell or use the relevant technology, which license might not be available on reasonable terms or at all; or redesign the products that use that technology.

If we are forced to take any of these actions, our business might be seriously harmed. Our insurance may not cover potential claims of this type or may not be adequate to indemnify us for all liability that could be imposed.

THE INABILITY TO OBTAIN ANY THIRD-PARTY LICENSE REQUIRED TO DEVELOP NEW PRODUCTS AND PRODUCT ENHANCEMENTS COULD REQUIRE US TO OBTAIN SUBSTITUTE TECHNOLOGY OF LOWER QUALITY OR PERFORMANCE STANDARDS OR AT GREATER COST, WHICH COULD SERIOUSLY HARM OUR BUSINESS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

From time to time, we may be required to license technology from third parties to develop new products or product enhancements. Third-party licenses may not be available to us on commercially reasonable terms or at all. Our inability to obtain any third-party license required to develop new products or product enhancements could require us to obtain substitute technology of lower quality or performance standards or at greater cost, which could seriously harm our business, financial condition and results of operations.

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GOVERNMENTAL REGULATIONS AFFECTING THE IMPORT OR EXPORT OF PRODUCTS COULD NEGATIVELY AFFECT OUR REVENUES.

Governmental regulation of imports or exports or failure to obtain required export approval of our encryption technologies could harm our international and domestic sales. The United States and various foreign governments have imposed controls, export license requirements and restrictions on the import or export of some technologies, especially encryption technology. In addition, from time to time, governmental agencies have proposed additional regulation of encryption technology, such as requiring the escrow and governmental recovery of private encryption keys.

In particular, in light of recent terrorist activity, governments could enact additional regulation or restrictions on the use, import or export of encryption technology. Additional regulation of encryption technology could delay or prevent the acceptance and use of encryption products and public networks for secure communications. This might decrease demand for our intended product offerings and services. In addition, some foreign competitors are subject to less stringent controls on exporting their encryption technologies. As a result, they may be able to compete more effectively than we can in the domestic and international network security market.

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MANAGEMENT COULD INVEST OR SPEND OUR CASH OR CASH EQUIVALENTS AND INVESTMENTS IN WAYS THAT MIGHT NOT ENHANCE OUR RESULTS OF OPERATIONS OR MARKET SHARE.

We have made no specific allocations of our cash or cash equivalents and investments. Consequently, management will retain a significant amount of discretion over the application of our cash or cash equivalents and investments and could spend the proceeds in ways that do not improve our operating results or increase our market share. In addition, these proceeds may not be invested to yield a favorable rate of return.

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PART II - OTHER INFORMATION

ITEM 6. EXHIBITS

See attached Exhibit Index.

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SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: May 21, 2007

PATRON SYSTEMS, INC.

(Registrant)

/S/ BRADEN WAVERLEY

By: Braden Waverley
Its: Chief Executive Officer

/S/ MARTIN T. JOHNSON

By: Martin T. Johnson
Its: Chief Financial Officer

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EXHIBIT INDEX

EXHIBIT

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| NUMBER | DESCRIPTION OF EXHIBIT |
|--------|---|
| 10.1 | Form of Stock Subscription Agreement and Mutual Release issued by Patron Systems, Inc. in favor of each of the Creditors and/or Claimants exchanging claims for shares of the Series A-1 Preferred Stock of Patron Systems, Inc. Incorporated by reference to Exhibit 10.4 to the Current Report on Form 8-K filed on March 31, 2006. |
| 10.2 | Employment Agreement dated February 17, 2006, between Patron Systems, Inc. and Braden Waverley. Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed February 23, 2006. |
| 10.3 | Employment Agreement dated February 17, 2006, between Patron Systems, Inc. and Martin Johnson. Incorporated by reference to Exhibit 10.2 to the Current Report on Form 8-K filed February 23, 2006. |
| 10.4 | Option Agreement dated February 17, 2006, between Patron Systems, Inc. and Braden Waverley. Incorporated by reference to Exhibit 10.3 to the Current Report on Form 8-K filed February 23, 2006. |
| 10.5 | Option Agreement dated February 17, 2006, between Patron Systems, Inc. and Martin Johnson. Incorporated by reference to Exhibit 10.4 to the Current Report on Form 8-K filed February 23, 2006. |
| 10.6 | Form of Subscription Agreement between Patron Systems, Inc. and each of the purchasers of shares of the Series A Preferred Stock of Patron Systems, Inc. Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed on March 31, 2006. |
| 10.7 | Form of Common Stock Purchase Warrant issued by Patron Systems, Inc. in favor of each of the purchasers of shares of the Series A Preferred Stock of Patron Systems, Inc. Incorporated by reference to Exhibit 10.2 to the Current Report on Form 8-K filed on March 31, 2006. |
| 10.8 | Registration Rights Agreement dated March 27, 2006, among Patron Systems, Inc. and each of the purchasers of shares of the Series A Preferred Stock of Patron Systems, Inc. Incorporated by reference to Exhibit 10.3 to the Current Report on Form 8-K filed on March 31, 2006. |
| 10.9 | Post Closing Escrow Agreement dated March 27, 2006, between Stubbs Alderton & Markiles, LLP and Patron Systems, Inc. Incorporated by reference to Exhibit 10.5 to the Current Report on Form 8-K filed on March 31, 2006. |
| 31.1 | Certification of Principal Executive Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Principal Financial Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

EX-1