

NETWORK 1 SECURITY SOLUTIONS INC  
Form 10QSB  
May 15, 2002

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U.S. SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-QSB

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES  
EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2002
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES  
EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_

COMMISSION FILE NUMBER 1-14896

NETWORK-1 SECURITY SOLUTIONS, INC.

-----  
(EXACT NAME OF SMALL BUSINESS ISSUER AS SPECIFIED IN ITS CHARTER)

DELAWARE

11-3027591

-----  
(STATE OR OTHER JURISDICTION OF  
INCORPORATION OR ORGANIZATION)

-----  
(IRS EMPLOYER  
IDENTIFICATION NO.)

1601 TRAPELO ROAD, RESERVOIR PLACE, WALTHAM, MASSACHUSETTS 02451

-----  
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)

781-522-3400

-----  
(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

As of May 1, 2002 there were 7,677,680 shares of Common Stock, \$.01 par value per share, 231,054 shares of Series D Convertible Preferred Stock, \$.01 par value per share, and 2,801,897 shares of Series E Convertible Preferred Stock, \$.01 par value per share, outstanding.

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

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NETWORK-1 SECURITY SOLUTIONS, INC.  
CONDENSED BALANCE SHEETS

	MARCH 31 2002
	-----
	(Unaudite
ASSETS	
-----	
Current assets:	
Cash and cash equivalents	\$ 5,701,0
Accounts receivable - net	94,0
Prepaid expenses and other current assets	109,0
	-----

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Total current assets		5,904,0
Equipment and fixtures		354,0
Capitalized software costs - net		581,0
Security deposits		16,0
		-----
		\$ 6,855,0
		=====
LIABILITIES		
-----		
Current liabilities:		
Accounts payable		307,0
Accrued expenses and other current liabilities		838,0
Deferred revenue		242,0
		-----
Total current liabilities		1,387,0
		-----
Commitments and contingencies		
STOCKHOLDERS' EQUITY		
-----		
Preferred stock - \$.01 par value; authorized 10,000,000 shares;		
Series D - 231,054 and 231,054 shares issued and outstanding, respectively		2,0
Series E - 2,801,897 and 3,191,037 shares issued and outstanding, respectively		28,0
Common stock - \$.01 par value; authorized 50,000,000 shares;		
7,677,680 and 6,781,374 shares issued and outstanding, respectively		77,0
Additional paid-in capital		41,402,0
Accumulated deficit		(36,041,0)
		-----
		5,468,0
		-----
		\$ 6,855,0
		=====

See notes to condensed financial statements

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### NETWORK-1 SECURITY SOLUTIONS, INC. CONDENSED STATEMENTS OF OPERATIONS

	THREE MONTHS ENDED MARCH 31,	
	2002	2001
	-----	-----
	(Unaudited)	(Unaudited)
Revenues:		
Licenses	\$ 68,000	\$ 396,000
Services	50,000	61,000
	-----	-----
Total revenues	118,000	457,000
Cost of revenues:		
Amortization of software development costs	70,000	62,000
Cost of licenses	3,000	14,000
Cost of services	42,000	62,000
	-----	-----
	115,000	138,000
	-----	-----
Gross profit	3,000	319,000

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Operating expenses:		
Product development	439,000	612,000
Selling and marketing	619,000	896,000
General and administrative	495,000	494,000
	1,553,000	2,002,000
Loss from continuing operations before interest	(1,550,000)	(1,683,000)
Interest income - net	26,000	41,000
Loss from continuing operations	(1,524,000)	(1,642,000)
Income from discontinued operations	0	630,000
Net loss	\$ (1,524,000)	\$ (1,012,000)
Per common share information - basic and diluted		
Loss from continuing operations	\$ (0.21)	\$ (0.26)
Income from discontinued operations	--	0.10
Net loss	\$ (0.21)	\$ (0.16)
Weighted average number of common shares outstanding	7,109,367	6,455,316

See notes to condensed financial statements

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NETWORK-1 SECURITY SOLUTIONS, INC.  
CONDENSED STATEMENTS OF CASH FLOWS

	THREE MONTHS END MARCH 31,	
	2002	
	(Unaudited)	(U
Cash flows from operating activities:		
Loss from continuing operations	\$ (1,524,000)	\$ (
Adjustments to reconcile net loss from continuing operations to net cash used in operating activities:		
Provision for doubtful accounts	0	
Amortization of compensatory stock options and warrants	0	
Depreciation and amortization	107,000	
Changes in:		
Accounts receivable	(32,000)	
Prepaid expenses and other current assets	4,000	
Accounts payable, accrued expenses and other current liabilities	65,000	
Interest Payable	0	
Deferred revenue	(3,000)	
Net cash used in continuing operations	(1,383,000)	(
Cash provided by (used in) discontinued operations	0	
Net cash used in operating activities	(1,383,000)	(

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Cash flows from investing activities:		
Acquisitions of equipment and fixtures	(72,000)	
Capitalized software costs	(90,000)	
Security deposit	(8,000)	
Net proceeds from sale of professional services group	0	
Net cash provided by (used in) investing activities	(170,000)	
Cash flows provided by financing activities:		
Proceeds from exercise of options and warrants	133,000	
Net decrease in cash and cash equivalents		
Cash and cash equivalents - beginning of period	7,121,000	
Cash and cash equivalents - end of period	\$ 5,701,000	\$
Supplemental disclosures of noncash investing and financing activity:		
Conversion of notes payable and accrued interest into 1,787 shares of common stock	\$ --	\$
Compensation charge for non qualified stock options related to employees of discontinued operations	\$ --	\$

See notes to condensed financial statements

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### NETWORK-1 SECURITY SOLUTIONS, INC. NOTES TO CONDENSED FINANCIAL STATEMENTS

#### 1. FINANCIAL STATEMENT PRESENTATION

a. The condensed financial statements included herein have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission with respect to Form 10-QSB. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures made herein are adequate to make the information contained herein not misleading. These interim financial statements and the notes thereto should be read in conjunction with the financial statements included in the Company's Form 10-KSB for the year ended December 31, 2001.

In the Company's opinion, all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of the information shown have been included.

b. The results of operations for the three months ended March 31, 2002 presented herein are not necessarily indicative of the results of operations that may be expected for the year ending December 31, 2002.

c. Basic loss per share is calculated by dividing the net loss by the weighted average number of outstanding common shares during the period. Diluted per share data includes the dilutive effects of options, warrants and convertible securities. As all potential common shares are anti-dilutive due to the loss from continuing operations, they are not included in the calculation of diluted loss per share.

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d. On March 4, 2002, the Company entered into a two year employment agreement commencing on March 11, 2002, with its new Chief Executive Officer and President, providing for an annual salary of \$200,000. In connection with the agreement, 1,200,000 options to purchase the Company's common stock at \$1.65 per share were granted, the exercise price being equal to the closing price of the Company's common stock on the grant date. The options vest 25% on the first anniversary of the grant date and 6.25% quarterly thereafter. The executive is also eligible to receive bonuses up to \$150,000 per year upon the attainment of specified performance targets. The options granted include 242,400 options issued under the Company's 1996 Plan and 957,600 options issued outside the plan.

### 2. SUBSEQUENT EVENTS

a. On April 18, 2002, in consideration of additional consulting and financial advisory services, the Company issued to CMH Capital Management Corp. ("CMH") an option to purchase 750,000 shares of the Common Stock at an exercise price of \$1.20 per share which was the market price of the Company's Common Stock on the date of issuance. Corey M. Horowitz, Chairman of the Board of Directors of the Company, is the sole owner and officer of CMH. The shares underlying the option shall vest over a three year period in equal amounts of 250,000 shares per year beginning April 18, 2003. In addition, the shares underlying the option shall vest in full in the event of a "change of control" or in the event that the closing price of the Company's common stock reaches a minimum of \$3.50 per share for twenty (20) consecutive trading days.

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

THIS QUARTERLY REPORT ON FORM 10-QSB CONTAINS FORWARD-LOOKING STATEMENTS WITHIN THE MEANING OF SECTION 27A OF THE SECURITIES ACT OF 1933, AS AMENDED (THE "SECURITIES ACT"), AND SECTION 21E OF THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED (THE "EXCHANGE ACT"). ACTUAL RESULTS, EVENTS AND CIRCUMSTANCES (INCLUDING FUTURE PERFORMANCE, RESULTS AND TRENDS) COULD DIFFER MATERIALLY FROM THOSE SET FORTH IN SUCH STATEMENTS DUE TO VARIOUS RISKS AND UNCERTAINTIES, INCLUDING, BUT NOT LIMITED TO, THOSE DISCUSSED IN THE COMPANY'S ANNUAL REPORT ON FORM 10-KSB FOR THE YEAR ENDED DECEMBER 31, 2001 IN THE SECTION ENTITLED "RISK FACTORS THAT MAY AFFECT FUTURE RESULTS" AS WELL AS THOSE RISKS DISCUSSED ELSEWHERE IN THIS REPORT.

#### Overview

The Company develops, markets, licenses and supports a suite of security software products designed to prevent unauthorized access to critical information residing on networked servers, desktops and laptops. In January 1999, the Company introduced its CYBERWALLPLUS family of network security products. The Company has made only limited sales of its CYBERWALLPLUS product, upon which an evaluation of its prospects and future performance can be made. Such prospects must be considered in light of the risks, expenses and difficulties frequently encountered in the introduction of new products and the shift from research and product development to commercialization of products based on rapidly changing technologies in a highly specialized and emerging market. The Company will be required to significantly expand its product and development capabilities, introduce new products, introduce enhanced features to existing products, expand its in-house sales force, establish and maintain distribution channels through third-party vendors, increase marketing expenditures, and attract additional qualified personnel. In addition, the Company must adapt to the demands of an emerging and rapidly changing computer

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network security market, intense competition and rapidly changing technology and industry standards. The Company may not be able to successfully address such risks, and the failure to do so would have a material adverse effect on the Company's business, results of operations and financial condition.

To date, the Company has incurred significant losses and, at March 31, 2002, had an accumulated deficit of \$ 36,041,000. In addition, since March 31, 2002, the Company has continued to incur significant operating losses. The Company expects to incur substantial operating expenses in the future to support its product development activities, and to expand its domestic and international sales activities and marketing capabilities. Management believes it currently has cash to fund its operations through December 31, 2002 (or earlier if the Company does not achieve certain revenue assumptions) (See "Liquidity and Capital Resources" on page 10 hereof).

On October 2, 2001, the Company completed a \$6.765 million private offering of Series E Preferred Stock and Warrants pursuant to a Securities Purchase Agreement with investors (the "Financing"). In accordance with the Securities Purchase Agreement, an aggregate of 3,191,037 shares of Series E Preferred Stock were sold to investors at a price of \$2.12 per share together with warrants to purchase 6,882,074 shares of Common Stock at an exercise price of \$1.27 per share. Each share of Series E Preferred Stock is convertible into two (2) shares of Common Stock, subject to adjustment. As the largest investor (\$2,300,000) in the Financing, FalconStor Software, Inc. ("FalconStor"), a storage networking infrastructure software company, received an additional warrant to purchase 500,000 shares of the Company's Common Stock (the "Additional Warrant"). The shares underlying the Series E Preferred Stock and the warrants (including the Additional Warrant) issued in the Financing were registered pursuant to a Form S-3 Registration Statement which was declared effective by the SEC on February 12, 2002. Simultaneously with the closing of the Financing, the Company and FalconStor entered into a ten year Distribution and License Agreement pursuant to which FalconStor has the right to distribute the Company's product offerings in its indirect and OEM channels. As part of the Distribution and License Agreement, FalconStor paid the Company a non-refundable advance of \$500,000 against future royalty payments of which, in accordance with accounting principles generally accepted in the United States of America, \$350,000 has been accounted for as the purchase price of the Additional Warrant and this resulted in total proceeds allocated to the Financing of \$7,115,000.

During the period October 2001 through March 2002, the Company hired fifteen (15) employees, including a new Chief Executive Officer and President (see below), a Senior Vice President of Marketing and Business Development, a Vice President of Channel Development and a Vice President and General Manager - Asia Pacific. The aggregate annual salaries for the fifteen (15) new employees is \$904,300.

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On March 11, 2002, the Company hired Richard Kosinski as Chief Executive Officer and President pursuant to a two (2) year Employment Agreement in which Mr. Kosinski receives an annual base salary of \$200,000 per year and is eligible to receive bonus compensation of up to \$150,000 per year. In addition, Mr. Kosinski was issued options to purchase 1,200,000 shares of the Company's Common Stock, at an exercise price of \$1.65 per share, which vest over a four (4) year period.

The Company's software products have not yet achieved market acceptance. The future success of the Company is largely dependent upon market acceptance of its CYBERWALLPLUS family of software products. While the Company believes that its family of software products offer advantages over competing products for network security, license revenue from network security software products since the introduction of FireWall/Plus (September 1995), a predecessor product line,

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through March 31, 2002 has only been \$4,777,000, including a non-refundable pre-paid royalty of \$500,000 in 1997. From January 1999 through March 31, 2002, license revenue from CYBERWALLPLUS has only been \$2,045,000. CYBERWALLPLUS may not achieve significant market acceptance. Revenue from such commercial products depend on a number of factors, including the influence of market competition, technological changes in the network security market, the Company's ability to design, develop and introduce enhancements on a timely basis, and the ability of the Company to successfully establish and maintain distribution channels. The failure of CYBERWALLPLUS to achieve significant market acceptance as a result of competition, technological change or other factors, would have a material adverse effect on the Company's business, operating results and financial condition.

The Company has committed significant product and development resources to its CYBERWALLPLUS family of products. The Company's anticipated levels of expenditures for product development are based on its plans for product enhancements and new product development. The Company capitalizes and amortizes software development costs in accordance with Statement of Financial Accounting Standards No. 86. These costs consist of salaries, consulting fees and applicable overhead.

### RESULTS OF OPERATIONS

THREE MONTHS ENDED MARCH 31, 2002 COMPARED TO THREE MONTHS ENDED MARCH 31, 2001

Revenues decreased by \$339,000 or 74%, from \$457,000 for the three months ended March 31, 2001 to \$118,000 for the three months ended March 31, 2002, primarily as a result of a decrease in license revenues during the three months ended March 31, 2002. License revenues decreased by \$328,000 or 83%, from \$396,000 for the three months ended March 31, 2001 to \$68,000 for the three months ended March 31, 2002. Network-1's revenues for the first quarter ended March 31, 2002 were impacted by the lack of enterprise licenses as well as the adverse economic conditions and reduced technology spending. Revenue for the three months ended March 31, 2001 included a large CyberwallPLUS server license issued to a major university of \$135,000 and \$103,000 in revenue from a distributor in China. Service revenues decreased by \$11,000 or 18%, from \$61,000 for the three months ended March 31, 2001 to \$50,000 for the three months ended March 31, 2002 primarily due to a reduction in training fees. The Company's revenues from customers in the United States represented 68% of its revenues during the three months ended March 31, 2001 and 90% of its revenues during the three months ended March 31, 2002, respectively.

Cost of revenues consists of amortization of software development costs, cost of licenses and cost of services. Amortization of software development costs increased by \$8,000 or 13%, from \$62,000 for three months ended March 31, 2001 to \$70,000 for the three months ended March 31, 2002, representing 16% and 103% of license revenues, respectively.

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Cost of licenses consists of software media (disks), documentation, product packaging, production costs and product royalties. Cost of licenses decreased by \$11,000 or 79%, from \$14,000 for the three months ended March 31, 2001 to \$3,000 for the three months ended March 31, 2002, each representing 4% of license revenues. Cost of licenses as a percentage of license revenues may fluctuate from period to period due to changes in product mix, changes in the number or size of transactions recorded in a given period or an increase or decrease in licenses of products which would require the Company to pay royalties to third parties.

Cost of services consists of salaries, benefits and overhead associated with the technical support of maintenance contracts. Cost of services decreased



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by \$20,000 or 32%, from \$62,000 for the three months ended March 31, 2001 to \$42,000 for the three months ended March 31, 2002, representing 102% and 84% of service revenues, respectively. The decrease in cost of services in both dollar amount and as a percentage of service revenues resulted primarily from decreased personnel costs in the group as a result of the capital preservation programs implemented last year. Cost of services as a percentage of service revenues may fluctuate from period to period due to changes in support headcount and related benefit costs.

Gross profit was \$319,000 for the three months ended March 31, 2001 compared to a gross profit of \$3,000 for the three months ended March 31, 2002 of, representing 70% and 3% of revenues, respectively. The decrease in gross profit was primarily due to the decrease in license revenue.

Product development consists of salaries, benefits, bonuses, travel and related costs of the Company's product development personnel, including consulting fees, the costs of computer equipment used in product and technology development. Product development expense decreased \$173,000 or 28%, from \$612,000 for three months ended March 31, 2001 to \$439,000 for the three months ended March 31, 2002, representing 134% and 372% of revenues, respectively. Total product development costs, including capitalized costs of \$125,000 for the three months ended March 31, 2001 and \$90,000 for the three months ended March 31, 2002, were \$737,000 and \$529,000 for the three months ended March 31, 2001 and March 31, 2002, respectively. The decrease in total product development costs was due primarily to the elimination of the use of outside programmer's services of \$168,000 and non-cash warrant compensation of \$109,000. These costs reductions were partially offset by the establishment of a development team to service the Asia Pacific region during the three month period ended March 31, 2002 at a cost of \$108,000.

Selling and marketing expenses consist primarily of salaries, including commissions, benefits, bonuses, travel, advertising, public relations, consultants and trade shows. Selling and marketing expenses decreased by \$277,000 or 31%, from \$896,000 for the three months ended March 31, 2001 to \$619,000 for the three months ended March 31, 2002, representing 196% and 525% of revenues, respectively. The decrease in selling and marketing expenses was due primarily to a decrease of \$210,000 in personnel costs and travel expenditures related to the headcount reduction in 2001 to preserve capital, and an \$85,000 reduction in advertising expenditures. These costs reductions were partially offset by the establishment of a sales team to service the Asia Pacific region for the three month period ended March 31, 2002 at a cost of \$39,000.

General and administrative expenses include employee costs, including salary, benefits, travel and other related expenses associated with management, finance and accounting operations, and legal and other professional services provided to the Company. General and administrative expenses increased by \$1,000 from \$494,000 for the three months ended March 31, 2001 to \$495,000 for the three months ended March 31, 2002, representing 108% and 419% of revenues, respectively.

The discontinued operations was sold on February 9, 2000 to Exodus Communications. The gain from discontinued operations in 2001 was attributed to the contingent payments and related contingent expenses pertaining to the sale received or paid in 2001.

No provision for or benefit from federal, state or foreign income taxes was recorded for three months ended March 31, 2001 or March 31, 2002 because the Company incurred net operating losses and fully reserved its deferred tax assets as their future realization could not be determined.

As a result of the foregoing, the Company had net loss of \$1,012,000 for

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the three months ended March 31, 2001 compared with a net loss of \$1,524,000 for the three months ended March 31, 2002.

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### Liquidity and Capital Resources

The Company's capital requirements have been and will continue to be significant and its cash requirements continue to exceed its cash flow from operations. At March 31, 2001, the Company had \$5,701,000 of cash and cash equivalents and working capital of \$4,517,000. In October 2001, the Company completed a private offering of \$6,765,000 of securities. The Company has financed its operations primarily through sales of equity and debt securities, and the sale of its professional services group. Net cash used in operating activities from continuing operations was \$1,496,000 during the three months ended March 31, 2001 and net cash used in operating activities from continuing operations was \$1,383,000 during the three months ended March 31, 2002. Net cash used in operating activities from continuing operations for three months ended March 31, 2002 was primarily attributable to the net loss from continuing operations of \$1,524,000, which was partially offset by the depreciation and amortization expense of \$107,000.

The Company's operating activities during the three months ended March 31, 2002 were financed primarily with the funds raised in 2001. The Company does not currently have a line of credit from a commercial bank or other institution.

The Company anticipates, based on currently proposed plans and assumptions (including the timetable of, costs and expenses associated with, and success of, its marketing efforts), that its current cash balance of approximately \$5,701,000 as of March 31, 2002, will be sufficient to satisfy the Company's operations and capital requirements through at least December 31, 2002. There can be no assurance, however, that such funds will not be expended prior thereto. In the event the Company's plans change, or its assumptions change, or prove to be inaccurate (due to unanticipated expenses, difficulties, delays or otherwise), the Company may have insufficient funds to support its operations prior to December 31, 2002 and will be required to seek additional financing sooner than currently anticipated. The Company does not have any current arrangements with respect to any additional financing. Consequently, there can be no assurance that any additional financing will be available to the Company when needed, on commercially reasonable terms or at all. The inability of the Company to obtain additional financing would have a material adverse effect on the Company, requiring it to curtail and possibly cease its operations. In addition, any additional equity financing may involve substantial dilution to the interests of the Company's then existing stockholders.

### Fluctuations in Operating Results

The Company anticipates significant quarterly fluctuations in its operating results in the future. The Company generally ships orders for commercial products as they are received and, as a result, does not have any material backlog. As a result, quarterly revenues and operating results depend on the volume and timing of orders received during the quarter, which are difficult to forecast. Operating results may fluctuate on a quarterly basis due to factors such as the demand for the Company's products, purchasing patterns and budgeting cycles of customers, the introduction of new products and product enhancements by the Company or its competitors, market acceptance of new products introduced by the Company or its competitors and the size, timing, cancellation or delay of customer orders, including cancellation or delay in anticipation of new product introduction or enhancement. Therefore, comparisons of quarterly operating results may not be meaningful and should not be relied upon, nor will they necessarily reflect the Company's future performance. Because of the foregoing factors, it is likely that in some future quarters the Company's operating

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results will be below the expectations of public market analysts and investors. In such event, the price of the Common Stock would likely be materially adversely affected.

The sales cycle for the Company's products can be lengthy and generally commences at the time a prospective customer demonstrates an interest in licensing a CYBERWALLPLUS solution which typically includes a 28-day free evaluation period and ends upon execution of a purchase order by the customer. The length of the sales cycle varies depending on the type and sophistication of the customer and the complexity of the operating system.

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### PART II. OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS.

None.

Item 2. CHANGES IN SECURITIES AND USE OF PROCEEDS.

None

Item 3. DEFAULTS UPON SENIOR SECURITIES.

None.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

None.

Item 5. OTHER INFORMATION.

None.

Item 6. EXHIBITS AND REPORTS ON FORM 8-K.

a). Exhibits

The exhibits in the following table have been filed as part of this Quarterly Report on Form 10-QSB:

None

b). Reports of Form 8-K.

On March 25, 2002, the Company filed a Current Report on Form 8-K related to the hiring of Richard Kosinski as CEO and President of the Company.

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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.

NETWORK-1 SECURITY SOLUTIONS, INC.

By: /s/ Richard Kosinski

-----  
Richard Kosinski  
President and Chief Executive Officer  
(Principal Executive Officer)

By: /s/ Murray P. Fish

-----  
Murray P. Fish  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

Date: May 15, 2002

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