SMART ONLINE INC
Form 10-K
March 25, 2008

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

FORM 10-K

(Mark One)
x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2007
or
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from __________ to __________

Commission file number 001-32634

SMART ONLINE, INC.
(Exact name of registrant as specified in its charter)

Delaware	**95-4439334**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
2530 Meridian Parkway, 2nd Floor	
Durham, North Carolina	**27713**
(Address of principal executive offices)	(Zip Code)

(919) 765-5000
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
N/A	**N/A**

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, $0.001 par value
(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes o No x

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

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

Large accelerated filer o	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No x

The aggregate market value of common stock held by non-affiliates of the registrant as of June 29, 2007 was approximately $24,932,947.50 (based on the closing sale price of $2.70 per share).

The number of shares of the registrant's Common Stock, $0.001 par value per share, outstanding as of March 19, 2008 was 18,184,628.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Proxy Statement to be delivered to shareholders in connection with the Annual Meeting of Shareholders to be held June 19, 2008 are incorporated by reference into Part III.

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PART I

Special Note Regarding Forward-Looking Statements

This Annual Report on Form 10-K contains forward-looking statements, within the meaning of Section 27A of the Securities Act of 1933, or the Securities Act, and Section 12E of the Securities Exchange Act of 1934, or the Exchange Act, regarding our plans, objectives, expectations, intentions, future financial performance, future financial condition, and other statements that are not historical facts. You can identify these statements by our use of the future tense, or by forward-looking words such as “may,” “will,” “expect,” “anticipate,” “believe,” “intend,” “estimate,” “continue,” a similar words and phrases. Examples of sections containing forward-looking statements include “Part I - ITEM 1. BUSINESS” and “Part II - ITEM 7. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.” These forward-looking statements are subject to risks, uncertainties, and assumptions that are difficult to predict. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Readers are directed to risks and uncertainties identified in “Part I - ITEM 1A. RISK FACTORS” and elsewhere in this report for factors that may cause actual results to be different than those expressed in these forward-looking statements. Except as required by law, we undertake no obligation to revise or update publicly any forward-looking statements for any reason.

ITEM 1. BUSINESS

General

In this Annual Report on Form 10-K, we refer to Smart Online, Inc. as “Smart Online,” the “Company,” “us,” “we,” and “our.” Smart Online was incorporated in Delaware in August 1993 and became a public company through a self registration in February 2005. Smart Online’s common stock trades on the OTC Bulletin Board, or the OTCBB, under the symbol “SOLN.”

We develop and market software products and services targeted to small businesses that have less than 50 employees. Our software products and services are delivered via a Software-as-a-Service, or SaaS, model. Our goal is to be the leading provider of SaaS applications in specific target market segments. We sell our SaaS products and services primarily through private label marketing partners. Our SaaS products and services are designed to be a value added solution that further strengthens our marketing partners’ existing solutions and drives additional revenue from their customer bases.

We generate revenue from two sources. Our first and primary revenue source is derived from sales of our SaaS applications for business management, web marketing, and e-commerce. Our second revenue source is derived from sales of consulting services that allow us to create custom business solutions that meet our partners’ marketing and information processing requirements. One of our current focuses is to design our consulting services to complement our SaaS applications, and we expect to provide complementary products and services in the future.

History

During the early stages of our development, we offered application-specific software using the “shrink-wrapped” method of distribution of diskettes and CD-ROMs, primarily through large office supply retailers such as Staples. In 2000, we made a significant change in our business strategy, and moved away from the development and sale of shrink-wrapped software products, bypassed the Application Service Provider, or ASP, model (where software can be accessed from the server by only one designated PC), and began developing SaaS applications for sale over the Internet.

Unlike the shrink wrapped distribution method that requires the end user to install, configure, and maintain hardware, software, and network services internally to support the software applications, or the ASP model that permits access to the software resident on a server by a user from one dedicated PC, our proprietary multi-tenant SaaS applications allow small businesses to subscribe and access those applications via a browser from any PC on an as needed basis, with very little or no installation or maintenance required by the end user.

A portion of our early stage SaaS sales and marketing strategy was to sell direct to the end user as well as through private label marketing partners. However, direct sales are no longer part of our marketing plan and we now sell primarily through syndication arrangements with our private label partners, who in turn market our SaaS applications to their customer bases.

In October 2005, we acquired substantially all of the assets of Computility, Inc., or Computility, based in Des Moines, Iowa. Computility was a privately held developer and distributor of sales force automation and customer relationship management, or SFA/CRM, software applications. We operated this business under the name Smart CRM, Inc. (d/b/a Computility), or Smart CRM. Upon our integration of Smart CRM's SFA/CRM application into our OneBiz^{SM} platform, we determined that the remaining operations of Smart CRM, specifically consulting and network management, were not integral to our ongoing operations and business model. On September 29, 2006, we sold these non-integral Smart CRM assets to Alliance Technologies, Inc., or Alliance, and reclassified Smart CRM as a discontinued operation. For further information, see Note 14, "Dispositions," in our consolidated financial statements included in this Annual Report on Form 10-K.

The Smart CRM assets sold to Alliance included the SFA/CRM software application developed and sold by Smart CRM and its predecessor in interest, Computility. We retained all rights relating to the derivative SFA/CRM SaaS application developed by us with Smart CRM and incorporated into our SaaS offerings.

In October 2005, we purchased all of the capital stock of iMart Incorporated, or iMart, a Michigan-based company providing multi-channel e-commerce systems. We currently operate this business as our wholly-owned subsidiary, Smart Commerce, Inc., or Smart Commerce.

Consistent with Statement of Financial Accounting Standards, or SFAS, No. 131, *Disclosures about Segments of an Enterprise and Related Information*, we have defined two reportable operating segments based on factors such as geography, how we manage our operations, and how the chief operating decision-maker views results. Those two segments are our core operations, or the Smart Online segment, and the operations of our wholly-owned subsidiary, or the Smart Commerce segment. We are currently evaluating the factors that will form the basis of our segmentation going forward.

The Smart Commerce segment's revenues are derived primarily from subscriptions to our multi-channel e-commerce systems, including domain name registration and email solutions, e-commerce solutions, website design, and website hosting, as well as consulting services. During 2007, we began integrating the e-commerce product line into our Smart Online segment. In 2007, our Smart Commerce segment generated 92% of our total consolidated revenue.

The Smart Online segment generates revenues from the development and distribution of internet-delivered SaaS small business applications through a variety of subscription, integration, and syndication channels. In 2007, our Smart Online segment generated 8% of our total consolidated revenue.

We include costs such as corporate general and administrative expenses and share-based compensation expenses that are not allocated to specific segments in the Smart Online segment, which includes the parent or corporate segment.

Principal Products and Services

Our principal products and services include:

- SaaS applications for business management, web marketing, and e-commerce;
- services that are designed to complement our product offerings and allow us to create custom business solutions that fit our end users' and channel partners' needs; and
- software business tools that assist customers in developing written content.

Our SaaS applications are designed to allow end users to access and work on information securely from any location where an Internet browser can be accessed. These applications include:

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e-Commerce– Our e-commerce applications are designed to give customers the capability to conduct transactions online. These applications also include inventory query, shopping cart, financial transactions, shipping, domain name registration and business to business communication for small businesses. We provide website design and launch and other consulting services in connection with these applications. Our e-commerce offerings are designed to help direct marketers increase sales, better leverage corporate resources, and deliver superior customer service.

SFA/CRM– Our SFA/CRM application is designed to allow end users to create standardized processes to define their sales approach, create marketing plans, and monitor and guide sales activities. Companies can utilize the customer service management feature to create, monitor, and track service requests. Companies can also display and present their business data with built-in report templates designed to provide information on sales activity, pipeline activity, revenue, and other relevant business data.

Business Dashboard– Our Business Dashboard application provides a snapshot of real-time business information in a single view, allowing users to monitor key business information about their company and employees. Examples of business information that end users may view on the dashboard include a list of key documents for the user, daily events scheduled, express packages shipped by a user, or a list of new employees. The dashboard displays different information to each user based upon their job function and access levels within the company.

Accounting– Our Accounting application is targeted for end users that want to create and maintain their accounting records online in a secure fashion, but do not have the resources to utilize traditional accounting applications designed for larger businesses. The Accounting application enables an end user to create invoices, record payments, print checks, produce real-time financial statements and reports, as well as manage accounts receivable and payable.

Human Resource Center– Our Human Resource, or HR, Center application is designed to allow companies to manage their daily human resources needs, including employee information, HR documents, performance reviews and compensation. The HR Center application also allows employers to manage the attendance records of each employee by creating and assigning vacation, sick leave, civil leave, and leave under other policies to each individual employee. The application allows an end user manager to monitor and approve or decline as needed time-off requests and automatically track how much time each employee has available on a per policy basis.

Calendar– Our Calendar application is a full function, easy-to-use online calendar. The Calendar application features daily, weekly, and monthly views, together with a mini-calendar that allows the end user to quickly browse to any date. Automated email reminders can be initiated, indicating notification of an upcoming event. In addition, employees may collaborate with their colleagues by sharing their calendar and events. This application also includes a to-do list to set up tasks, assign priorities and due dates, and mark tasks as complete as they are finished.

Contacts– Our Contacts application is designed to provide companies with an online business contact management system. Contacts can be sorted by group or alphabetically. End users can add, edit, and remove contact groups as needed, or they can use the default set of groups. Furthermore, contacts may be shared between colleagues.

In addition to our SaaS application, we offer a variety of business tools through the private label sites of some of our marketing partners. Our business tools include Business Plan Writer, Business Letters, Business and Legal Forms, Marketing Plan Writer, Job Description Writer, Employee Policy Manual Writer, Government Forms, and Business Guides.

We also provide services that are designed to complement our product offerings and allow us to create custom business solutions that fit our channel partners' needs. The services offered to our partners include business consulting, graphics design, website content syndication, specialized compensation calculation, inventory management, domain name registration, personalized email creation, express package tracking, business plan writing, e-commerce tax services, e-mail marketing, web analytics, warehouse order fulfillment, and business and personal calculators.

Mode of Operations

Software-as-a-Service Model– We follow the SaaS model for delivering our products and services to our marketing partners' end users. The on demand SaaS model developed using multi-tenant architecture enables end users to visit a website and use the SaaS applications, all via a web browser, with no installation, no special information technology knowledge, and no maintenance. The SaaS application is transformed into a service that can be used anytime and anywhere by the end user. Multi-tenant SaaS applications also permit us to add needed functionality to our applications in one location for the benefit of all end users. This capability allows us to provide upgrades universally.

Integration and Sharing – Our SaaS applications permit the sharing of information (with selectivity and control options) between members of an organization. Each company that subscribes to our SaaS applications via our marketing partner can have multiple members or employees who share information with one another. Information entered by one employee can be shared and modified by one or more other employees who have the appropriate access authority. Several of the applications within our applications are integrated with one another. Integration means that certain applications communicate and share information with other applications and are updated in real time.

Target Market and Sales Channels

Our consistent focus from the beginning has been to design software products and services to help start and run small businesses with 50 or fewer employees more efficiently. The small business market is diverse, fragmented, yet very large and, we believe, underserved. We have focused on offering a wide range of software products that combine simplicity and affordability and that meet the needs of small businesses with capabilities that typically can be afforded only by much larger companies. We believe the growth rate of small businesses using web-based applications will exceed the growth rate of large enterprises. Although our ultimate end users are small businesses and entrepreneurs who access our software products and services via the web, we do not market our products and services directly to these end users. Instead, we target marketing partners that are vertical intermediaries in industries such as agriculture, finance, telecommunications, direct selling, retail, and technology as channels to reach these small business customers.

During 2007, we increased our revenue through a combination of the following sales and marketing initiatives:

- soliciting and contracting with additional marketing partners,
- actively managing relationships with our partners to increase sales, and
- bundling our software in packages targeted to different types of industries within the small business market.

Principal Customers

Currently, we consider two customers as our major customers, and the loss of either of these customers could have a material adverse effect on our business. Both of these customers currently subscribe to the applications offered by, and purchase professional services from, our Smart Commerce segment.

Britt Worldwide, or BWW, is an entity that indirectly controls a significant number of independent business owners, or IBOs, who currently subscribe to our services. The aggregate of the subscriptions from these IBOs represented approximately 24% of our consolidated revenue for the fiscal year ended December 31, 2007. BWW became a customer of ours after we acquired iMart in October 2005 and represented 45% of our revenues in 2006. Although our revenue is derived from the IBOs, BWW can influence the actions of the IBOs, so this revenue has been aggregated for purposes of this Annual Report on Form 10-K.

UR Association, or URA, is an entity that indirectly controls a significant number of IBOs who currently subscribe to our services. The aggregate of the subscriptions from these IBOs represented approximately 11% of our consolidated revenue for the fiscal year ended December 31, 2007. URA became our customer in 2007. Although our revenue is derived from the IBOs, URA can influence the actions of the IBOs, so this revenue has been aggregated for purposes of this Annual Report on Form 10-K.

Vera Bradley Designs, Inc., or Vera Bradley, a manufacturer of high quality handbags, luggage, and other accessories, is also a major customer. Vera Bradley accounted for approximately 22% of our consolidated revenues for fiscal year ended December 31, 2007. Vera Bradley became our customer in 2006 and represented 28% of our revenues in 2006.

Research & Development

During 2006, we devoted a substantial amount of time and effort toward the research and development of our OneBiz^{SM} platform and the associated applications. In the fourth quarter of 2006, we began to shift our focus from research and development to the marketing of our latest products. In the second half of 2007, as part of a general restructuring, we began to conduct an evaluation of our technology, platforms, and applications in an effort to document and improve upon our current product offerings and determine which applications, if any, should be discontinued. We expect this process to continue through the third quarter of 2008. We also use offshore resources to provide assistance in delivering solutions and enhancing some applications for the SaaS marketplace.

Our research and development costs were approximately $2.5 million and $2.0 million in 2007 and 2006, respectively. We have not engaged in any customer-sponsored research and development.

Competition

The market for small business software applications in both the traditional and SaaS environments is highly competitive and subject to rapid changes in technology and delivery. The direct competition we face depends on the software application within our platforms and the delivery model capabilities of our competitors.

We have two primary categories of competitors: large companies that offer a wide range of products for small to medium-size businesses and other companies that offer only one or two software products that compete with our broad range of software products. Our principal direct competition comes from several large vendors of SaaS applications for small businesses that sell many products similar to ours. These competitors include, but are not limited to, Microsoft, Oracle, NetSuite, Intuit, SAP, Sage, Yahoo!, and Google.

We also expect to face competition from new entrants that will market SaaS applications similar to ours to small businesses. Companies that offer only one or two products that compete with our suite of SaaS applications include:

- Accounting software applications: Netsuite, Intuit, SAP, Sage, Microsoft, and others.
- Human resource software applications: ADP, Sage, and others.
- e-Commerce solutions: Register.com, GoDaddy.com, 1and1 Internet, eBay’s Storefront, Yahoo! Store, Microsoft, NetSuite, Intuit, and others.
- SFA/CRM applications: Microsoft, Sage, Salesforce.com, Netsuite, and others.

Although we believe we offer highly competitive services and software, many of our competitors do or may have greater resources and a larger number of total customers for their products and services. In addition, a number of our competitors already sell certain products to our current and potential customers, as well as to systems integrators and other vendors and service providers. These competitors may be able to respond more quickly to new or emerging technologies and changes in customer requirements, or to devote greater resources to the development, promotion, and sale of their products, than we can. It is also possible that new competitors or alliances among competitors or other third parties may emerge and rapidly acquire market share. Increased competition may result in price reductions, reduced gross margins, and change in market share, any of which could adversely impact our revenue and profitability targets and timetables.

On each competitive front, we seek to compete against these larger and better financed companies primarily by offering an extensive suite of SaaS applications that are useful to small businesses. We believe we offer more SaaS applications and features specifically targeted to small businesses than most of our competitors. We believe one distinctive value our applications offer is the integration of the applications. To meet our business objectives, we will need to enhance our current applications and continue to develop high quality and competitively priced new applications for our SaaS offerings. If we are unable to do so, our revenue and profitability targets and timetables could be adversely impacted.

To compete effectively in the SaaS market, we plan to leverage our private label marketing partners who sell our SaaS applications to their small business customers. We offer existing and potential partners to private label our SaaS applications to their small business customers as value added products and services. This strategy is designed to enable us to compete effectively in the SaaS market by leveraging the marketing resources and customer relationships of our marketing partners.

Intellectual Property Rights

Our success depends, in part, upon our proprietary technology, processes, trade secrets, and other proprietary information and our ability to protect this information from unauthorized disclosure and use. We rely on a combination of copyright, trade secret, and trademark laws, confidentiality procedures, contractual provisions, and other similar measures to protect our proprietary information. We do not own any issued patents or have any patent applications pending. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy or design around certain aspects of our SaaS offerings or to obtain and use information that we regard as proprietary, and third parties may attempt to develop similar technology independently. In addition, the laws of some foreign countries do not protect our proprietary rights to the same extent as do the laws of the United States, and we expect that it will become more difficult to monitor use of our products if we develop an international presence.

We have registered copyrights, trademarks and registered service marks on several products and data services. These marks include, but are not limited to: Smart Online, OneBiz, Smart Attorney, Smart Business Plan, iMart, and OneDomain.

As part of our efforts to protect our proprietary information, we enter into license agreements with our customers and nondisclosure agreements with certain of our employees, consultants, and corporate partners. These agreements generally contain restrictions on disclosure, use, and transfer of our proprietary information for a period of three years. We also employ various physical and technological security measures to protect our software source codes, technology, and other proprietary information.

Employees

As of December 31, 2007, we had 50 full-time employees. No employees are known by us to be represented by a collective bargaining agreement, and we have never experienced a strike or similar work stoppage.

Available Information

Our corporate information is accessible through our main web portal at www.smartonline.com. We are not including the information contained on our website as a part of, or incorporating it by reference into this Annual Report on Form 10-K. Although we endeavor to keep our website current and accurate, there can be no guarantees that the information on our website is up to date or correct. We make available free of charge through our website our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish such material to, the Securities and Exchange Commission, or the SEC. These reports may be accessed by following the link under “Investors--SEC Filings” on our website.

ITEM 1A. RISK FACTORS

We operate in a dynamic and rapidly changing business environment that involves substantial risk and uncertainty, and these risks may change over time. The following discussion addresses some of the risks and uncertainties that could cause, or contribute to causing, actual results to differ materially from expectations. In evaluating our business, you should pay particular attention to the descriptions of risks and uncertainties described below and in other sections of this document and our other filings. These risks and uncertainties are not the only ones we face. Additional risks and uncertainties not presently known to us, which we currently deem immaterial, or that are similar to those faced by other companies in our industry or business in general may also affect our business. If any of the risks described below actually occurs, our business, financial condition, or results of operations could be materially and adversely affected.

Historically, we have operated at a loss, and we continue to do so.

We have had recurring losses from operations and continue to have negative cash flows. If we do not become cash flow positive through additional financing or growth, we may have to cease operations and liquidate our business. Our working capital, including our line of credit with Paragon Commercial Bank, or Paragon, February 2007 equity financing transaction, and convertible note financing, should fund our operations for the next 18 months. As of March 19, 2007, we have approximately $2.0 million available on our revolving line of credit and approximately $5.2 million available through our convertible note financing. Factors such as the commercial success of our existing services and products, the timing and success of any new services and products, the progress of our research and development efforts, our results of operations, the status of competitive services and products, the timing and success of potential strategic alliances or potential opportunities to acquire technologies or assets, the charges filed against a former officer and a former employee filed by the SEC and the United States Attorney General, and the pending shareholder class action lawsuit may require us to seek additional funding sooner than we expect. If we fail to raise sufficient financing, we will not be able to implement our business plan and we may have to liquidate our business.

Our business is dependent upon the development and market acceptance of our applications.

Our future financial performance and revenue growth will depend, in part, upon the successful development, integration, introduction, and customer acceptance of our software applications. Thereafter, other new products, either developed or acquired, and enhanced versions of our existing applications will be critically important to our business. Our business could be harmed if we fail to deliver timely enhancements to our current and future solutions that our customers desire. We also must continually modify and enhance our services and products to keep pace with market demands regarding hardware and software platforms, database technology, information security, and electronic commerce technical standards. Our business could be harmed if we fail to achieve the improved performance that customers want with respect to our current and future product offerings. There can be no assurance that our products will achieve widespread market penetration or that we will derive significant revenues from the sale or licensing of our platforms or applications.

We have not yet demonstrated that we have a successful business model.

We have invested significantly in infrastructure, operations, and strategic relationships to support our SaaS delivery model, which represents a significant departure from the delivery strategies that other software vendors and we have traditionally employed. To maintain positive margins for our small business services, our revenues will need to continue to grow more rapidly than the cost of such revenues. We anticipate that our future financial performance and revenue growth will depend, in large part, upon our Internet-based SaaS business model and the results of our sales efforts to reach agreements with syndication partners with small business customer bases, but this business model may become ineffective due to forces beyond our control that we do not currently anticipate. Although we entered into agreements, including a marketing referral agreement, with 14 new partners and customers during 2007, our success depends in part on the ultimate success of our syndication partners and referral partners and their ability to market our products and services successfully. Our partners are not obligated to provide potential customers to us. In addition, some of these third parties have entered, and may continue to enter, into strategic relationships with our competitors. Further, many of our strategic partners have multiple strategic relationships, and they may not regard us as significant for their businesses. Our strategic partners may terminate their respective relationships with us, pursue other partnerships or relationships, or attempt to develop or acquire products or services that compete with our products or services. Our strategic partners also may interfere with our ability to enter into other desirable strategic relationships. If we are unable to maintain our existing strategic relationships or enter into additional strategic relationships, we will have to devote substantially more resources to the distribution, sales, and marketing of our products and services.

In addition, our end users currently do not sign long-term contracts. They have no obligation to renew their subscriptions for our services after the expiration of their initial subscription period and, in fact, they have often elected not to do so. Our end users also may renew for a lower-priced edition of our services or for fewer users. Many of our end users utilize our services without charge. These factors make it difficult to accurately predict customer renewal rates. Our customers' renewal rates may decline or fluctuate as a result of a number of factors, including when we begin charging for our services, their dissatisfaction with our services, and their capability to continue their operations and spending levels. If our customers do not renew their subscriptions for our services or we are not able to increase the number of subscribers, our revenue may decline and our business will suffer.

The SEC action against us, the SEC and criminal actions brought against certain former employees, and related stockholder and other lawsuits have damaged our business, and they could damage our business in the future.

The lawsuit filed against us by the SEC, the SEC and criminal actions filed against a former officer and a former employee, the class action lawsuit filed against us and certain current and former officers, directors, and employees, and the lawsuit filed by a former executive officer against us has harmed our business in many ways, and may cause further harm in the future. Since the initiation of these actions, our ability to raise financing from new investors on favorable terms has suffered due to the lack of liquidity of our stock, the questions raised by these actions, and the resulting drop in the price of our common stock. As a result, we may have to rely solely on existing investors for such financing, and may not raise sufficient financing, if necessary, in the future.

Legal and other fees related to these actions have also reduced our cash flow. We make no assurance that we will not continue to experience additional harm as a result of these matters. The time spent by our management team and directors dealing with issues related to these actions detracts from the time they spend on our operations, including strategy development and implementation. These actions also have harmed our reputation in the business community, jeopardized our relationships with vendors and customers, and decreased our ability to attract qualified personnel, especially given the media coverage of these events.

In addition, we face uncertainty regarding amounts that we may have to pay as indemnification to certain current and former officers, directors, and employees under our Bylaws and Delaware law with respect to these actions, and we may not recover all of these amounts from our directors and officers liability insurance policy carrier. Our Bylaws and Delaware law generally require us to indemnify, and in certain circumstances advance legal expenses to, current and former officers, directors, employees, and agents against claims arising out of such person's status or activities as our officer, director, employee, or agent, unless such person (i) did not act in good faith and in a manner the person reasonably believed to be in or not opposed to our best interests or (ii) had reasonable cause to believe his conduct was unlawful. As of March 19, 2008, there are SEC and criminal actions pending against a former executive officer and a former employee who have requested that we indemnify them and advance expenses incurred by them in the defense of those actions. Also, a stockholder class action lawsuit has been filed against us and certain of our current and former officers, directors, and employees. The SEC, criminal, and stockholder actions are more fully described in Part I, Item 3, "Legal Proceedings," in this report.

Generally, we are required to advance defense expenses prior to any final adjudication of an individual's culpability. The expense of indemnifying our current and former directors, officers, and employees for their defense or related expenses in connection with the current actions may be significant. Our Bylaws require that any director, officer, employee, or agent requesting advancement of expenses enter into an undertaking with us to repay any amounts advanced unless it is ultimately determined that such person is entitled to be indemnified for the expenses incurred. This provides us with an opportunity, depending upon the final outcome of the matters and the Board's subsequent determination of such person's right to indemnity, to seek to recover amounts advanced by us. However, we may not be able to recover any amounts advanced if the person to whom the advancement was made lacks the financial resources to repay the amounts that have been advanced. If we are unable to recover the amounts advanced, or can do so only at great expense, our operations may be substantially harmed as a result of loss of capital.