

ZIX CORP
Form 10-Q
August 09, 2010

Table of Contents

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

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2010

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: 0-17995

ZIX CORPORATION

(Exact Name of Registrant as Specified in its Charter)

Texas

(State of Incorporation)

75-2216818

(I.R.S. Employer Identification Number)

2711 North Haskell Avenue

Suite 2200, LB 36

Dallas, Texas 75204-2960

(Address of Principal Executive Offices)

(214) 370-2000

(Registrant's Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

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

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

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

Class

Outstanding at August 2, 2010

Common Stock, par value \$0.01 per share

64,071,326

INDEX

| | Page Number |
|--|----------------|
| PART I FINANCIAL INFORMATION | |
| Item 1. Financial Statements (Unaudited) | |
| <u>Condensed Consolidated Balance Sheets at June 30, 2010 and December 31, 2009</u> | 3 |
| <u>Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2010 and 2009</u> | 4 |
| <u>Condensed Consolidated Statement of Stockholders' Equity (Deficit) for the six months ended June 30, 2010</u> | 5 |
| <u>Condensed Consolidated Statements of Cash Flows for the six months ended June 30, 2010 and 2009</u> | 6 |
| <u>Notes to Condensed Consolidated Financial Statements</u> | 7 |
| Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations | 12 |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk | 19 |
| Item 4. Controls and Procedures | 19 |
| PART II OTHER INFORMATION | |
| Item 1. Legal Proceedings | 19 |
| Item 1A. Risk Factors | 19 |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds | 19 |
| Item 3. Defaults Upon Senior Securities | 19 |
| Item 4. (Removed and Reserved) | 19 |
| Item 5. Other Information | 19 |
| Item 6. Exhibits | 20 |
| <u>EX-10.1</u> | |
| <u>EX-10.2</u> | |
| <u>EX-31.1</u> | |
| <u>EX-31.2</u> | |
| <u>EX-32.1</u> | |

Table of Contents**ZIX CORPORATION****CONDENSED CONSOLIDATED BALANCE SHEETS**

| | June 30, 2010 (unaudited) | December 31, 2009 |
|--|--|------------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 17,477,000 | \$ 13,287,000 |
| Marketable securities | | 25,000 |
| Receivables, net | 564,000 | 760,000 |
| Prepaid and other current assets | 854,000 | 1,142,000 |
| Total current assets | 18,895,000 | 15,214,000 |
| Property and equipment, net | 2,240,000 | 2,137,000 |
| Goodwill | 2,161,000 | 2,161,000 |
| Other assets | 164,000 | 236,000 |
| Total assets | \$ 23,460,000 | \$ 19,748,000 |
| LIABILITIES AND STOCKHOLDERS EQUITY (DEFICIT) | | |
| Current liabilities: | | |
| Accounts payable | \$ 672,000 | \$ 769,000 |
| Accrued expenses | 2,393,000 | 3,124,000 |
| Deferred revenue | 16,454,000 | 14,478,000 |
| License subscription note payable | 131,000 | 126,000 |
| Total current liabilities | 19,650,000 | 18,497,000 |
| Long-term liabilities: | | |
| Deferred revenue | 1,803,000 | 2,821,000 |
| License subscription note payable | 119,000 | 186,000 |
| Deferred rent | 198,000 | 233,000 |
| Total long-term liabilities | 2,120,000 | 3,240,000 |
| Total liabilities | 21,770,000 | 21,737,000 |
| Commitments and contingencies (see Note 8) | | |
| Stockholders' equity (deficit): | | |
| Preferred stock, \$1 par value, 10,000,000 shares authorized; none issued and outstanding | | |
| Common stock, \$0.01 par value, 175,000,000 shares authorized; 66,362,868 issued and 64,035,687 outstanding in 2010 and 66,053,772 issued and 63,726,591 outstanding in 2009 | 664,000 | 661,000 |
| Additional paid-in capital | 338,815,000 | 337,352,000 |
| Treasury stock, at cost; 2,327,181 common shares in 2010 and 2009 | (11,507,000) | (11,507,000) |
| Accumulated deficit | (326,282,000) | (328,495,000) |
| Total stockholders' equity (deficit) | 1,690,000 | (1,989,000) |

Edgar Filing: ZIX CORP - Form 10-Q

| | | |
|--|---------------|---------------|
| Total liabilities and stockholders' equity (deficit) | \$ 23,460,000 | \$ 19,748,000 |
|--|---------------|---------------|

See notes to condensed consolidated financial statements.

3

Table of Contents**ZIX CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(Unaudited)

| | Three Months Ended June | | Six Months Ended June 30, | |
|--|--------------------------------|----------------|----------------------------------|----------------|
| | 2010 | 2009 | 2010 | 2009 |
| Revenues | \$ 8,915,000 | \$ 7,371,000 | \$ 17,331,000 | \$ 14,627,000 |
| Cost of revenues | 1,970,000 | 2,368,000 | 3,826,000 | 4,839,000 |
| Gross profit | 6,945,000 | 5,003,000 | 13,505,000 | 9,788,000 |
| Operating expenses: | | | | |
| Research and development | 1,307,000 | 1,747,000 | 2,755,000 | 3,478,000 |
| Selling, general and administrative | 4,062,000 | 5,228,000 | 8,443,000 | 9,872,000 |
| Total operating expenses | 5,369,000 | 6,975,000 | 11,198,000 | 13,350,000 |
| Operating income (loss) | 1,576,000 | (1,972,000) | 2,307,000 | (3,562,000) |
| Other income, net | 15,000 | 73,000 | 44,000 | 141,000 |
| Income (loss) before income taxes | 1,591,000 | (1,899,000) | 2,351,000 | (3,421,000) |
| Provision for income taxes | (90,000) | (26,000) | (138,000) | (46,000) |
| Net income (loss) | \$ 1,501,000 | \$ (1,925,000) | \$ 2,213,000 | \$ (3,467,000) |
| Basic income (loss) per common share | \$ 0.02 | \$ (0.03) | \$ 0.03 | \$ (0.05) |
| Diluted income (loss) per common share | \$ 0.02 | \$ (0.03) | \$ 0.03 | \$ (0.05) |
| Basic weighted average common shares outstanding | 63,976,551 | 63,319,482 | 63,883,974 | 63,319,482 |
| Diluted weighted average common shares outstanding | 66,368,548 | 63,319,482 | 65,977,451 | 63,319,482 |

See notes to condensed consolidated financial statements.

Table of Contents**ZIX CORPORATION****CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY (DEFICIT)**

(Unaudited)

| | Stockholders Equity | | | | | |
|--|----------------------------|---------------|-------------------------------|-----------------|--------------------|--|
| | Common Stock | | Additional Paid-In | Treasury | Accumulated | Total Stockholders Equity (Deficit) |
| | Shares | Amount | Capital | Stock | Deficit | |
| Balance, December 31, 2009 | 66,053,772 | \$ 661,000 | \$ 337,352,000 | \$ (11,507,000) | \$ (328,495,000) | \$ (1,989,000) |
| Issuance of common stock upon exercise of stock options | 309,096 | 3,000 | 466,000 | | | 469,000 |
| Employee stock-based compensation costs | | | 976,000 | | | 976,000 |
| Non-employee stock-based compensation costs | | | 21,000 | | | 21,000 |
| Net income | | | | | 2,213,000 | 2,213,000 |
| Balance, June 30, 2010 | 66,362,868 | \$ 664,000 | \$ 338,815,000 | \$ (11,507,000) | \$ (326,282,000) | \$ 1,690,000 |

See notes to condensed consolidated financial statements.

Table of Contents**ZIX CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Unaudited)

| | Six Months Ended June 30, | |
|---|----------------------------------|----------------|
| | 2010 | 2009 |
| Operating activities: | | |
| Net income (loss) | \$ 2,213,000 | \$ (3,467,000) |
| Non-cash items in net income (loss): | | |
| Depreciation and amortization | 685,000 | 648,000 |
| Employee stock-based compensation costs | 976,000 | 1,353,000 |
| Non-employee stock-based compensation costs | 21,000 | 16,000 |
| Changes in deferred taxes | 7,000 | 7,000 |
| Changes in operating assets and liabilities: | | |
| Receivables | 196,000 | (152,000) |
| Prepaid and other assets | 353,000 | 374,000 |
| Accounts payable | (222,000) | 409,000 |
| Deferred revenue | 958,000 | (19,000) |
| Accrued and other liabilities | (766,000) | 592,000 |
| Net cash provided by (used in) operating activities | 4,421,000 | (239,000) |
| Investing activities: | | |
| Purchases of property and equipment | (663,000) | (515,000) |
| Sales of marketable securities | 25,000 | |
| Restricted cash and marketable securities, net | | 3,000 |
| Net cash (used in) investing activities | (638,000) | (512,000) |
| Financing activities: | | |
| Proceeds from exercise of stock options | 469,000 | |
| Payment of license subscription note payable | (62,000) | |
| Net cash provided by financing activities | 407,000 | |
| Increase (decrease) in cash and cash equivalents | 4,190,000 | (751,000) |
| Cash and cash equivalents, beginning of period | 13,287,000 | 13,245,000 |
| Cash and cash equivalents, end of period | \$ 17,477,000 | \$ 12,494,000 |

See notes to condensed consolidated financial statements.

Table of Contents**ZIX CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

1. Basis of Presentation

The accompanying condensed consolidated financial statements of Zix Corporation (ZixCorp, the Company, we, our, us) should be read in conjunction with the audited consolidated financial statements included in the Company's 2009 Annual Report to Shareholders on Form 10-K. These financial statements are unaudited, but have been prepared in the ordinary course of business for the purpose of providing information with respect to the interim periods. Management of the Company believes that all adjustments necessary for a fair presentation for such periods have been included and are of a normal recurring nature. The results of operations for the three and six month periods ended June 30, 2010, are not necessarily indicative of the results to be expected for the full year.

2. Recent Accounting Standards and Pronouncements

To be adopted in 2010 or beyond:

In October 2009, the FASB issued guidance that provides principles for allocation of consideration among a revenue arrangement's multiple-elements, allowing more flexibility in identifying and accounting for separate deliverables under an arrangement. The guidance introduces an estimated selling price method for valuing the elements of a bundled arrangement if vendor-specific objective evidence or third-party evidence of selling price is not available, and significantly expands related disclosure requirements. It is effective on a prospective basis for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Alternatively, adoption may be on a retrospective basis, and early application is permitted. The potential impact of this standard is being evaluated. We do not expect the adoption of this statement to have a material impact on our consolidated financial statements or footnote disclosures.

International Financial Reporting Standards (IFRS) On August 27, 2008, the U.S. Securities and Exchange Commission (SEC) announced that it will issue for comment a proposed roadmap regarding the potential use by U.S. issuers of financial statements prepared in accordance with IFRS. IFRS is a comprehensive series of accounting standards published by the International Accounting Standards Board (IASB). Under the proposed roadmap, we could be required in fiscal 2014 to prepare financial statements in accordance with IFRS, and the SEC is expected to make a determination in 2011 regarding the mandatory adoption of IFRS. We will continue to monitor the development of the potential implementation of IFRS.

3. Segment Information

We have concluded that our business has two reportable segments: Email Encryption and e-Prescribing. Our senior management team measures the performance of each segment and determines the related allocation of resources. In 2009 we announced our plan to exit the e-Prescribing business by December 31, 2010. Throughout 2010 we expect to wind down the remaining obligations related to this business segment.

To determine the allocation of resources, the senior management team generally assesses the performance of each segment based on revenue, gross profit, and direct expenses which include research and development expenses and selling and marketing expenses that are directly attributable to the segments. Most assets and most corporate costs are not allocated to the segments and are not used to determine resource allocation. The accounting policies of the reportable segments are the same as those applied to the consolidated financial statements.

Corporate includes charges such as corporate management, compliance and other non-operational activities that cannot be directly attributed to a reporting segment. The following table shows Operating results broken out by segment, including Corporate, for the three month periods ended June 30, 2010 and 2009.

| Three Months Ended June 30, 2010 | Email | | | Total |
|---|-------------------|----------------------|------------------|--------------|
| | Encryption | e-Prescribing | Corporate | |
| Revenues | \$ 8,194,000 | \$ 721,000 | \$ | \$ 8,915,000 |
| Cost of revenues | 1,570,000 | 400,000 | | 1,970,000 |

Edgar Filing: ZIX CORP - Form 10-Q

| | | | | |
|---|--------------|------------|----------------|--------------|
| Gross profit | 6,624,000 | 321,000 | | 6,945,000 |
| Direct expenses | 3,632,000 | 133,000 | | 3,765,000 |
| Segment contribution | 2,992,000 | 188,000 | | 3,180,000 |
| Unallocated (expense) income | | | | |
| General and administrative expense | | | (1,604,000) | (1,604,000) |
| Other income, net | | | 15,000 | 15,000 |
| Total unallocated (expense) income | | | (1,589,000) | (1,589,000) |
| Income (loss) before provision for income taxes | \$ 2,992,000 | \$ 188,000 | \$ (1,589,000) | \$ 1,591,000 |

Table of Contents

| Three Months Ended June 30, 2009 | Email Encryption | e-Prescribing | Corporate | Total |
|---|-----------------------------|----------------------|------------------|----------------|
| Revenues | \$ 6,379,000 | \$ 992,000 | \$ | \$ 7,371,000 |
| Cost of revenues | 1,088,000 | 1,280,000 | | 2,368,000 |
| Gross profit | 5,291,000 | (288,000) | | 5,003,000 |
| Direct expenses | 2,979,000 | 1,749,000 | | 4,728,000 |
| Segment contribution (loss) | 2,312,000 | (2,037,000) | | 275,000 |
| Unallocated (expense) income | | | | |
| General and administrative expense | | | (2,247,000) | (2,247,000) |
| Other income, net | | | 73,000 | 73,000 |
| Total unallocated (expense) income | | | (2,174,000) | (2,174,000) |
| Income (loss) before provision for income taxes | \$ 2,312,000 | \$ (2,037,000) | \$ (2,174,000) | \$ (1,899,000) |

The following table shows Operating results broken out by segment, including Corporate, for the six month periods ended June 30, 2010 and 2009.

| Six Months Ended June 30, 2010 | Email Encryption | e-Prescribing | Corporate | Total |
|---|-----------------------------|----------------------|------------------|---------------|
| Revenues | \$ 15,673,000 | \$ 1,658,000 | \$ | \$ 17,331,000 |
| Cost of revenues | 3,072,000 | 754,000 | | 3,826,000 |
| Gross profit | 12,601,000 | 904,000 | | 13,505,000 |
| Direct expenses | 7,409,000 | 426,000 | | 7,835,000 |
| Segment contribution | 5,192,000 | 478,000 | | 5,670,000 |
| Unallocated (expense) income | | | | |
| General and administrative expense | | | (3,363,000) | (3,363,000) |
| Other income, net | | | 44,000 | 44,000 |
| Total unallocated (expense) income | | | (3,319,000) | (3,319,000) |
| Income (loss) before provision for income taxes | \$ 5,192,000 | \$ 478,000 | \$ (3,319,000) | \$ 2,351,000 |

| Six Months Ended June 30, 2009 | Email Encryption | e-Prescribing | Corporate | Total |
|---------------------------------------|-----------------------------|----------------------|------------------|---------------|
| Revenues | \$ 12,621,000 | \$ 2,006,000 | \$ | \$ 14,627,000 |
| Cost of revenues | 2,101,000 | 2,738,000 | | 4,839,000 |
| Gross profit | 10,520,000 | (732,000) | | 9,788,000 |

Edgar Filing: ZIX CORP - Form 10-Q

| | | | | |
|---|--------------|----------------|----------------|----------------|
| Direct expenses | 5,735,000 | 3,594,000 | | 9,329,000 |
| Segment contribution (loss) | 4,785,000 | (4,326,000) | | 459,000 |
| Unallocated (expense) income | | | | |
| General and administrative expense | | | (4,021,000) | (4,021,000) |
| Other income, net | | | 141,000 | 141,000 |
| Total unallocated (expense) income | | | (3,880,000) | (3,880,000) |
| Income (loss) before provision for income taxes | \$ 4,785,000 | \$ (4,326,000) | \$ (3,880,000) | \$ (3,421,000) |

Depreciation and amortization expense:

The following table shows depreciation and amortization expense by segment.

| | Six Months Ended June 30, | |
|----------------------------|----------------------------------|-------------|
| | 2010 | 2009 |
| Email Encryption | \$ 535,000 | \$ 386,000 |
| e-Prescribing | 73,000 | 179,000 |
| Unallocated | 77,000 | 83,000 |
| Total depreciation expense | \$ 685,000 | \$ 648,000 |

Table of Contents**Allocated costs:**

For the periods presented we allocated certain fixed expenses as well as certain shared expenses to our segment businesses. Fixed expenses include expenses related to occupancy, information technology and commercial insurance and are generally allocated to the business segments based on direct headcount. Shared expenses include expenses incurred by our customer service, network operations, quality assurance, research and development and marketing departments and are generally allocated based on percent of effort. Shared expenses are largely fixed in nature and are expected to remain flat or only slightly increase in 2010.

Included in the increase in Email Encryption Cost of revenues and Direct expenses for the second quarter 2010 compared to the same quarter last year was an increase of approximately \$500,000 for allocated fixed and shared expenses which were spread approximately evenly between Cost of revenues and Direct expenses. This increase resulted from lower headcount in e-Prescribing and the shift in effort directed toward the Email Encryption business. The remaining increase in Email Encryption resulted from normal planned increases in the budget in support of Email Encryption growth. The expense reductions in e-Prescribing were attributable primarily to lower headcount and other expense reductions resulting from diminished recruiting and deployment activity in this business segment and the impact of lower allocated costs.

The Email Encryption increase in allocated fixed and shared expenses was approximately \$1,000,000 for the six month period ended June 30, 2010 compared to the same period last year. This increase was spread approximately evenly between Cost of revenues and Direct expenses. The remaining increase in Email Encryption resulted primarily from planned increases in support of Email Encryption growth.

In our first quarter 2010 Form 10-Q we disclosed \$1,148,000 of expenses which included planned increases to the Email Encryption business when it should have only included the fixed and shared allocated expenses absorbed by this business segment. We therefore have adjusted this amount down to approximately \$500,000. This revision is only to the supplement disclosure included with the segment data, which was accurately stated.

The expense reductions in e-Prescribing resulted primarily from lower headcount and other expense reductions attributable to diminished recruiting and deployment activity in this business segment combined with the impact of lower allocated costs. We expect the Email Encryption business will absorb approximately \$800,000 to \$1,000,000 of allocated fixed and shared expenses during the second half of 2010 depending on the pace of the of the e-Prescribing wind down.

The wind down of the e-Prescribing business is progressing well and there have been minimal technical support issues, which have allowed us to utilize some of the e-Prescribing team to support the Email Encryption business as time permits. This movement of resources is producing a shift in expenses between the two businesses and will not change total expense. At the conclusion of the wind down of the e-Prescribing business unit, certain allocated expenses previously absorbed by this business unit will remain. We now anticipate approximately \$600,000 to \$700,000 depending on the pace of the wind down, of fixed and shared expenses to be absorbed by the remaining business unit, Email Encryption, and those expenses will be reflected in its expenses beginning in 2011.

Other segment information:

Revenues from international customers and long-lived assets located outside of the U.S. are not material to the consolidated financial statements.

Total assets by segment are shown below. Assets reported under each segment include only those that provide a direct and exclusive benefit to that segment. Assets assigned to each segment include accounts receivable and related allowances, prepaid and other assets, certain property and equipment and related accumulated depreciation, goodwill, and intangible assets and related accumulated amortization. All other corporate and shared assets are recorded under Corporate.

| | June 30, 2010 | December 31, 2009 |
|----------------------|----------------------|--------------------------|
| Total assets: | | |
| Email Encryption | \$ 3,672,000 | \$ 3,781,000 |
| e-Prescribing | 250,000 | 416,000 |

| | | |
|--------------|---------------|---------------|
| Corporate | 19,538,000 | 15,551,000 |
| Total assets | \$ 23,460,000 | \$ 19,748,000 |

4. Stock Options and Stock-based Employee Compensation

As of June 30, 2010, there were 9,648,929 options outstanding and 1,105,285 available for grant. Of this amount, 861,262 options were available for grant to employees and 244,023 were available for grant to the Company's directors. For the three month and six month periods ended June 30, 2010, the total stock-based employee compensation expense was recorded to the following line items of the Company's condensed consolidated statements of operations:

| | Three Months Ended June 30, 2010 | Six Months Ended June 30, 2010 |
|-------------------------------------|---|---|
| Cost of revenues | \$ 54,000 | \$ 101,000 |
| Research and development | 51,000 | 98,000 |
| Selling, general and administrative | 372,000 | 777,000 |
| Stock-based compensation expense | \$ 477,000 | \$ 976,000 |

Table of Contents

There were 139,460 and 309,096 stock options exercised for the three and six month periods ended June 30, 2010. No options were exercised for the comparable periods in 2009. The excess tax deficiency recorded in the three and six month periods ended June 30, 2010, related to these option exercises was \$17,000 and \$30,000, respectively. A deferred tax asset totaling \$263,000 and \$422,000, resulting from stock-based compensation expense relating to the Company's U.S. operations, was recorded for the six month periods ended June 30, 2010, and 2009, respectively. These deferred tax assets were fully reserved because of the Company's historical net losses for its U.S. operations. As of June 30, 2010, there was \$1,616,000 of total unrecognized stock-based compensation related to non-vested stock-based compensation awards granted under the stock option plans. This cost is expected to be recognized over a weighted average period of 0.92 years.

Stock Option Activity

The following is a summary of all stock option transactions for the three months ended June 30, 2010:

| | Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (Yrs) | Aggregate Intrinsic Value |
|--------------------------------------|-----------|--|--|---------------------------------|
| Outstanding at March 31, 2010 | 9,965,678 | \$ 4.17 | | |
| Granted at market price | 63,000 | \$ 2.41 | | |
| Cancelled or expired | (240,289) | \$ 3.49 | | |
| Exercised | (139,460) | \$ 1.57 | | |
| Outstanding at June 30, 2010 | 9,648,929 | \$ 4.21 | 5.61 | \$ 1,999,000 |
| Options exercisable at June 30, 2010 | 8,546,137 | \$ 4.45 | 5.20 | \$ 1,589,000 |

At June 30, 2010, we had 2,974,330 stock options outstanding in which the exercise price was lower than the market value of the Company's common stock.

For additional information regarding the Company's Stock Options and Stock-based Employee Compensation, see Note 4 to the consolidated financial statements contained in our Form 10-K for the fiscal year ended December 31, 2009.

5. Supplemental Cash Flow Information

Supplemental cash flow information relating to taxes and non-cash activities:

| | Six Months Ended June 30, 2010 | 2009 |
|--|-----------------------------------|-----------|
| Cash paid for interest | \$ 12,000 | \$ |
| Cash income tax payments | \$149,000 | \$142,000 |
| Non-cash investing and financing activities: | | |
| Assets sold to customers as part of their subscription service | \$ | \$ 2,000 |
| Payables related to purchases of fixed assets | \$125,000 | \$153,000 |
| Issuance of license subscription note payable | \$ | \$390,000 |
| Amounts reclassified from Notes payable to Accounts payable | \$ | \$ 19,000 |

6. Receivables, net

| June 30, | December 31, |
|----------|--------------|
|----------|--------------|

| | 2010 | 2009 |
|---|-------------|-------------|
| Receivables | \$ 602,000 | \$ 786,000 |
| Allowance for returns and doubtful accounts | (38,000) | (26,000) |
| Note receivable | 484,000 | 484,000 |
| Allowance for note receivable | (484,000) | (484,000) |
| Receivables, net | \$ 564,000 | \$ 760,000 |

The allowance for doubtful accounts includes all specific accounts receivable which we believe are likely not collectible based on known information. In addition, we record 2.5% of all accounts receivable greater than 90 days past due, net of those accounts specifically reserved, as a general allowance against accounts that could potentially become uncollectible.

The note receivable represents the remaining outstanding balance of an original note related to the sale of a product line in 2005 in the amount of \$540,000.

Table of Contents**7. Earnings Per Share and Potential Dilution**

Basic earnings per share are computed using the weighted average number of common shares outstanding for the period. The dilutive effect of potential common shares outstanding is included in diluted earnings per share. The computations for basic and diluted earnings per share for the three and six month periods ended June 30, 2010 and 2009 are as follows:

| | Three Months ended June 30, | | Six Months ended June 30, | |
|-------------------------------------|------------------------------------|----------------|----------------------------------|----------------|
| | 2010 | 2009 | 2010 | 2009 |
| Net income (loss) | \$ 1,501,000 | \$ (1,925,000) | \$ 2,213,000 | \$ (3,467,000) |
| Basic weighted average shares | 63,976,551 | 63,319,482 | 63,883,974 | 63,319,482 |
| Effect of dilutive securities: | | | | |
| Employee and director stock options | 845,705 | | 748,190 | |
| Warrants | 1,546,292 | | 1,345,287 | |
| Potential dilutive common shares | 66,368,548 | 63,319,482 | 65,977,451 | 63,319,482 |
| Net earnings (loss) per share | | | | |
| Basic | \$ 0.02 | \$ (0.03) | \$ 0.03 | \$ (0.05) |
| Diluted | \$ 0.02 | \$ (0.03) | \$ 0.03 | \$ (0.05) |

During the three and six month periods ended June 30, 2010, weighted average shares related to certain stock options of 7,444,427 and 7,405,497 respectively, were excluded from the calculation of diluted earnings per share because the stock options were anti-dilutive. Anti-dilutive warrants of 3,664,902 in both the three and six month periods ended June 30, 2010, were also excluded from the calculation. For the three and six month periods ended June 30, 2009, the assumed exercise of common stock equivalents would be anti-dilutive, as a net loss was reported. Common shares excluded from the computation of diluted loss per common share for the three and six month periods ended June 30, 2009, was 9,661,326 for stock options and 10,260,246 for warrants.

8. Commitments and contingencies

A summary of our fixed contractual obligations and commitments at June 30, 2010, is as follows:

| | Payments Due by Period | | | Beyond 3 Years |
|-----------------------------------|-------------------------------|---------------|------------------------|-----------------------|
| | Total | 1 Year | Years 2 & 3 | |
| Operating leases | \$ 4,287,000 | \$ 1,219,000 | \$ 1,959,000 | \$ 1,109,000 |
| License subscription note payable | 250,000 | 131,000 | 119,000 | |
| Total cash obligations | 4,537,000 | 1,350,000 | 2,078,000 | 1,109,000 |
| Interest on obligations | 21,000 | 16,000 | 5,000 | |
| Total | \$ 4,558,000 | \$ 1,366,000 | \$ 2,083,000 | \$ 1,109,000 |

We have not entered into any material, non-cancelable purchase commitments at June 30, 2010.

Claims and Proceedings

We are, from time to time, involved in various legal proceedings that arise in the ordinary course of business. We do not believe the outcome of those legal proceedings either individually or taken as a whole, will have a material adverse effect on our consolidated financial condition, results of operations or cash flows. However, we cannot predict

with certainty any eventual loss or range of possible loss related to such matters.

9. Fair Value Measurements

Financial Accounting Standards Board (FASB) guidance regarding fair value measurement establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets for identical assets or liabilities; Level 2, defined as inputs other than quoted prices for similar assets and liabilities in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs for which little or no market data exists, therefore requiring an entity to develop its own assumptions.

For certain of the Company s financial instruments, including cash and cash equivalents, trade receivables, and accounts payable, the fair values approximate carrying values due to the short-term maturities of these instruments. The carrying values of other current assets and accrued expenses are also not recorded at fair value, but approximate fair values primarily due to their short-term nature.

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****NOTE ON FORWARD-LOOKING STATEMENTS AND RISK FACTORS**

Statements in this report, or in our news releases, websites, public filings, investor and analyst conferences or elsewhere, which are not purely historical facts or which necessarily depend upon future events, including statements about trends, uncertainties, hopes, beliefs, anticipations, expectations, plans, intentions or strategies for the future, may be forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934. Forward-looking statements involve risks and uncertainties that could cause actual events or results to differ materially from the events or results described in the forward-looking statements, including risks and uncertainties described in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009. Any of these risk factors could have a material adverse effect on our business, financial condition or financial results and reduce the value of an investment in our securities. We may not succeed in addressing these and other risks associated with an investment in our securities, with our business and with our achieving any forward-looking statements. Readers are cautioned not to place undue reliance on forward-looking statements. All forward-looking statements are based upon information available to us on the date the statements are made. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Overview

We are a leader in providing secure, Internet-based applications in a Software as a Service (SaaS) model. Our focus is the operation of an Email Encryption Service, which has been designed with the customers' most important relationships in mind. More than 1,200 hospitals and over 1,300 financial institutions, including some of the most influential companies and government organizations use our Email Encryption Service. Wellpoint, Humana, and the SEC are among these notable customers. Our Email Encryption Service is enhanced by ZixDirectorySM, which contains more than 22 million email addresses. ZixDirectorySM allows for emails to be sent seamlessly whenever possible, across the largest email encryption community in the world. Email Encryption is one of two reporting segments we currently operate; the other segment we operate is e-Prescribing (see Note 3 to the condensed consolidated financial statements). In 2009 we announced our plan to exit this segment of our business by December 31, 2010. Throughout 2010 we expect to wind down the remaining obligations related to the e-Prescribing business.

The business operations and service offerings are supported by the ZixData Center, a network operations center dedicated to secure electronic transaction processing. The operations of the ZixData Center are independently audited annually to maintain AICPA SysTrustSM certification in the areas of security, confidentiality, integrity and availability. Auditors also produce a SAS70 Type II report on the effectiveness of operational controls used over the audit period. The center is staffed 24 hours a day with a proven 99.99% reliability. Whether it is delivery of email, prescriptions or other sensitive information, we enable communications to be sent in a trusted, safe, and secure manner. This is our core competency and we believe it is a competitive advantage.

Critical Accounting Policies and Estimates

The preparation of financial statements and related disclosures in accordance with accounting principles generally accepted in the United States requires the Company's management to make estimates and assumptions that affect the amounts reported in the Company's condensed consolidated financial statements and accompanying notes. Actual results could differ from these estimates and assumptions. Critical accounting policies and estimates are defined as those that are both most important to the portrayal of the Company's financial condition and results and require management's most subjective judgments.

We describe our significant accounting policies in Note 2, *Summary of Significant Accounting Policies*, of the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K, for the year ended December 31, 2009. We discuss our *Critical Accounting Policies and Estimates* in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2009.

Table of Contents**Results of Operations****Second Quarter 2010 Summary of Operations****Financial**

Revenue for the quarter ended June 30, 2010, was \$8,915,000 compared with \$7,371,000 for the same period in 2009 representing a 21% increase.

Gross profit for the quarter ended June 30, 2010, was \$6,945,000 or 78% of revenues compared with \$5,003,000 or 68% of revenues for the comparable period in 2009.

Email Encryption gross profit was \$6,624,000 or 81% of revenues compared with \$5,291,000 or 83% of revenues for the comparable period in 2009.

e-Prescribing gross profit was \$321,000 or 45% of revenues compared with gross loss of \$288,000 or 29% of revenues for the comparable period in 2009.

Net income for the quarter ended June 30, 2010, was \$1,501,000 compared with a net loss of \$1,925,000 in 2009. Included in net income for the quarter ended June 30, 2010, was approximately \$169,000 of non recurring severance costs related to the wind down of our e-Prescribing business.

Ending cash and cash equivalents were \$17,477,000 on June 30, 2010, compared with \$13,287,000 on December 31, 2009.

Operations

For the Email Encryption service, new first year orders (NFYOs) for the quarter ended June 30, 2010, were \$2,108,000. June 30, 2010, Email Encryption backlog was \$45,593,000.

The wind down of our e-Prescribing business is progressing well. We have worked out appropriate resolutions with all of our major customers in this business and have protected our brand in the important healthcare vertical market. As disclosed in our July 27, 2010, press release, we expect this business to generate a small amount of profit for 2010.

Revenues

Email Encryption and e-Prescribing are primarily subscription-based services. The following table sets forth a period-over-period comparison of the Company's revenues:

| | Three Months Ended | | 3-month Variance | | Six Months Ended June | | 6-month Variance | |
|---------------|--------------------|--------------|---------------------|-------|-----------------------|---------------|---------------------|-------|
| | June 30, | | 2010 vs. 2009 | | 30, | | 2010 vs. 2009 | |
| | 2010 | 2009 | \$ | % | 2010 | 2009 | \$ | % |
| Email | | | | | | | | |
| Encryption | \$ 8,194,000 | \$ 6,379,000 | \$ 1,815,000 | 28% | \$ 15,673,000 | \$ 12,621,000 | \$ 3,052,000 | 24% |
| e-Prescribing | 721,000 | 992,000 | (271,000) | (27%) | 1,658,000 | 2,006,000 | (348,000) | (17%) |
| Total | | | | | | | | |
| revenues | \$ 8,915,000 | \$ 7,371,000 | \$ 1,544,000 | 21% | \$ 17,331,000 | \$ 14,627,000 | \$ 2,704,000 | 18% |

The increase in Email Encryption revenue was due to continued cumulative growth in our subscription model, where strong new orders combined with a sustained high level of customer retention. Our second quarter 2010 Email Encryption revenues include a catch-up entry of approximately \$300,000 of deferred revenue we recognized due to our implementing an automated method of closing out our service offering deployments. This method shortens the time for reporting deployments and allows us to more effectively synchronize revenue recognition with service deployment. Because we expected to recognize that deferred revenue during the third and fourth quarters of 2010, the catch-up entry is not anticipated to have any material impact on our projected annual revenue for 2010.

The decrease in e-Prescribing revenue is largely due to a reduction in renewal revenue, which is expected to continue as we exit the business. Due to the ongoing wind down of the e-Prescribing business and the absence of new deployments, we expect e-prescribing revenue to decline throughout 2010, to approximately 60% of the 2009 annual total.

Revenue Indicators Backlog and Orders

Email Encryption backlog Our Email Encryption customer order backlog is a key measurement of our success in signing new customers and retaining existing customers. Our end-user order backlog is comprised of contractually bound agreements that we expect to amortize into revenue as the services are performed. The timing of revenue recognition is affected by both the length of time required to deploy a service and the length of the service contract.

Table of Contents

As of June 30, 2010, Email Encryption backlog was \$45,593,000 and we expect approximately 57% of the backlog to be recognized as revenue during the next twelve months. As of June 30, 2010, the Email Encryption backlog was comprised of the following elements: \$17,657,000 of deferred revenue that has been billed and paid, \$4,830,000 billed but unpaid, and approximately \$23,107,000 of unbilled backlog relating primarily to the second and third years of multi-year contracts.

Email Encryption Orders Total orders for Email Encryption were \$9,598,000 and \$9,966,000 for the three month periods ended June 30, 2010 and 2009, respectively. The decline in total Email Encryption orders in the second quarter 2010 compared to the same period in 2009 was attributable to a higher number of larger sized contacts scheduled for renewal in the second quarter 2009 and the length of those contracts. Total orders includes anticipated revenues from customer orders, which management groups into three categories: first twelve months of renewing contracts, NFYOs, and new and renewing orders beyond the first year of service in a multi-year service contract. NFYOs were \$2,108,000 and \$1,650,000 for the three month periods ended June 30, 2010 and 2009, respectively. We believe the increase in demand is the result of customers' increased awareness of the need to protect sensitive information in transit and customers' efforts to comply with new federal and state privacy regulations.

e-Prescribing As of June 30, 2010, our e-Prescribing backlog was \$663,000, which we expect to recognize as revenue in 2010. As of June 30, 2010, the e-Prescribing backlog was comprised of \$600,000 of deferred revenue that has been billed and paid and \$63,000 billed but unpaid. This backlog includes revenue from approximately 1,250 actively writing prescribers with subscriptions through our December 2010 exit of the e-Prescribing business. We have concluded appropriate resolutions with our major customers to fulfill our contractual obligations while also renewing contracts for service through the remainder of the wind down period as noted above.

Cost of Revenues

The following table sets forth a period-over-period comparison of the cost of revenues by product line.

| | Three Months Ended June 30, | | 3-month Variance | | Six Months Ended June 30, | | 6-month Variance | |
|---------------------------|--------------------------------|--------------|---------------------|-------|------------------------------|--------------|------------------|-------|
| | | | 2010 vs. 2009 | | | | 2010 vs. 2009 | |
| | 2010 | 2009 | \$ | % | 2010 | 2009 | \$ | % |
| Email | | | | | | | | |
| Encryption | \$ 1,570,000 | \$ 1,088,000 | \$ 482,000 | 44% | \$ 3,072,000 | \$ 2,101,000 | \$ 971,000 | 46% |
| e-Prescribing | 400,000 | 1,280,000 | (880,000) | (69%) | 754,000 | 2,738,000 | (1,984,000) | (72%) |
| Total cost of revenues | \$ 1,970,000 | \$ 2,368,000 | \$ (398,000) | (17%) | \$ 3,826,000 | \$ 4,839,000 | \$ (1,013,000) | (21%) |

As we wind down the e-Prescribing business, we have reduced headcount and expenses for activities relating to recruiting new prescribers and deploying new service. Additionally, due to reduced e-Prescribing business activity, that business is absorbing a smaller portion of the allocated costs described in the Segment information and the Email Encryption business has absorbed more of the allocated costs. The increase in Cost of revenues for Email Encryption for both the three and six month periods ended June 30, 2010, compared to the same time periods last year resulted primarily from these higher allocations.

For the three month period ended June 30, 2010, the Cost of revenues improvement resulted primarily from (i) a \$210,000 decrease in salary and benefits for individuals performing deployment activities due to a decrease in average headcount in the e-Prescribing product line, (ii) a \$108,000 decrease in e-Prescribing device costs, (iii) a \$40,000 decrease in travel costs, primarily related to e-Prescribing field services, and (iv) a \$40,000 net decrease in other various non-people costs primarily associated with decreased deployments of our e-Prescribing product. Additionally, due to lower than anticipated e-Prescribing technical support requirements, we moved a few people who were previously assigned to e-Prescribing Research and development to Email Encryption Customer support to assist with higher order volumes in that business. That reassignment reduced e-Prescribing Research and development costs and

increased Email Encryption Cost of revenues.

For the six month period ended June 30, 2010, the Cost of revenues improvement resulted primarily from (i) a \$630,000 decrease in salary and benefits for individuals performing deployment activities due to a decrease in average headcount in the e-Prescribing product line, (ii) a \$188,000 decrease in e-Prescribing device costs, (iii) a \$90,000 decrease in travel costs, primarily related to e-Prescribing field services, (iv) an \$84,000 decrease in stock-based compensation expense, and (v) a \$21,000 net decrease in other various non-people costs primarily associated with decreased deployments of our e-Prescribing product. Although to a lesser extent, the year to date results include the aforementioned reassignment of e-Prescribing personnel.

Email Encryption Email Encryption's Cost of revenues is comprised of costs related to operating and maintaining the ZixData Center, a field deployment team, customer service and support and the amortization of Company-owned, customer-based computer appliances. For Email Encryption, a significant portion of the total cost of revenues relates to the ZixData Center, which currently has excess capacity.

e-Prescribing e-Prescribing's Cost of revenues is comprised of costs related to operating and maintaining the ZixData Center and customer service and support.

Table of Contents**Research and Development Expenses**

The following table sets forth a period-over-period comparison of our research and development expenses.

| | Three Months Ended | | 3-month | | Six Months Ended June | | 6-month | |
|--------------------------------|--------------------|--------------|---------------|-------|-----------------------|--------------|---------------|-------|
| | June 30, | | Variance | | 30, | | Variance | |
| | 2010 | 2009 | 2010 vs. 2009 | % | 2010 | 2009 | 2010 vs. 2009 | % |
| | | | \$ | % | | | \$ | % |
| Email | | | | | | | | |
| Encryption | \$ 1,248,000 | \$ 821,000 | \$ 427,000 | 52% | \$ 2,557,000 | \$ 1,624,000 | \$ 933,000 | 57% |
| e-Prescribing | 59,000 | 926,000 | (867,000) | (94%) | 198,000 | 1,854,000 | (1,656,000) | (89%) |
| Total Research and development | \$ 1,307,000 | \$ 1,747,000 | \$ (440,000) | (25%) | \$ 2,755,000 | \$ 3,478,000 | \$ (723,000) | (21%) |

Research and development expenses consist primarily of salary, benefits, and stock-based compensation for our development staff and other non-people costs associated with enhancing our existing products and services and developing new products and services. For the periods presented, we allocated total Research and development expenses to our segment businesses based on percent of effort applied by our engineering resources to each business segment. With the wind down of the e-Prescribing business, the percentage of shared research and development resources allocated to Email Encryption was increased resulting in a higher Research and development expense to the Email Encryption business.

The increase in Email Encryption Research and development expense for the three and six month periods ended June 30, 2010, compared to the same periods last year is primarily attributable to the increase in shared cost allocation and additional resources. The decrease in e-Prescribing resulted primarily from a reduction in the same allocated shared costs for both the three and six month periods ended June 30, 2010, compared to the same periods in 2009. Further decreases in e-Prescribing Research and development were attributable to decreases in salary and benefits resulting from lower average headcount totaling \$379,000 and \$607,000 for the three and six month periods ended June 30, 2010, respectively, compared to the same periods in 2009.

In the second quarter of 2010 the on-going investment in our Email Encryption products included delivery of new versions of both ZixGateway and ZixPort that provide advanced protocol handling, security functions and support for multiple languages. We also designed a set of tools to improve the automation level and efficiency of the customer provisioning process for our resellers and distributors. This will allow our third-party channels to deploy our service more quickly.

Selling, General and Administrative Expenses

The following table sets forth a period-over-period comparison of our selling, general and administrative expenses.

| | Three Months Ended | | 3-month | | Six Months Ended June | | 6-month | |
|--------------------------------|--------------------|--------------|---------------|-------|-----------------------|--------------|---------------|-------|
| | June 30, | | Variance | | 30, | | Variance | |
| | 2010 | 2009 | 2010 vs. 2009 | % | 2010 | 2009 | 2010 vs. 2009 | % |
| | | | \$ | % | | | \$ | % |
| Email | | | | | | | | |
| Encryption | | | | | | | | |
| Selling and marketing expenses | \$ 2,140,000 | \$ 1,986,000 | \$ 154,000 | 8% | \$ 4,381,000 | \$ 3,791,000 | \$ 590,000 | 16% |
| e-Prescribing | 52,000 | 796,000 | (744,000) | (93%) | 176,000 | 1,689,000 | (1,513,000) | (90%) |
| Selling and | | | | | | | | |

| | | | | | | | | |
|---|--------------|--------------|----------------|-------|--------------|--------------|----------------|-------|
| marketing expenses Corporate Selling, general and administrative expenses | 1,870,000 | 2,446,000 | (576,000) | (24%) | 3,886,000 | 4,392,000 | (506,000) | (12%) |
| Total Selling, general and administrative | \$ 4,062,000 | \$ 5,228,000 | \$ (1,166,000) | (22)% | \$ 8,443,000 | \$ 9,872,000 | \$ (1,429,000) | (14%) |

Selling, general and administrative expenses (SG&A) consist primarily of salary, stock-based compensation and benefit costs for marketing, selling, executive and administrative personnel as well as costs associated with promotions, professional services, travel and general corporate activities.

Email Encryption selling and marketing expenses for the three month period ended June 30, 2010, increased due to (i) a \$68,000 increase in salaries and variable compensation resulting from an increase in average headcount and sales commissions resulting from higher NFYOs, (ii) a \$70,000 increase in allocated costs for occupancy and information technology and (iii) a \$16,000 net increase in trade show expenses and various other selling and marketing costs.

The year to date increase in Email Encryption selling and marketing expenses resulted from (i) a \$398,000 increase in salaries and variable compensation driven primarily by sales commissions resulting from higher NFYOs, and (ii) a \$200,000 increase in allocated costs due to the wind down of the e-Prescribing business for occupancy and information technology.

Table of Contents

The reductions for e-Prescribing for both the three and six month periods ended June 30, 2010, compared to the same periods last year, resulted from a reduction in salary and benefit expense, travel expense and other expenses consistent with the wind down of that business segment.

The decrease in Corporate General and administrative expenses for the three month period ended June 30, 2010, compared to the same period last year resulted from (i) a \$292,000 decrease in salaries and benefits primarily attributable to a non-recurring severance expense in the second quarter of 2009 and (ii) a \$298,000 decrease in professional fees, primarily outside legal fees.

Year to date, the cost decreases in the second quarter of 2010 were substantially offset by higher professional fees, primarily outside legal fees, in the first quarter 2010 compared to the same period last year.

Other Income, net

Other income, net consists primarily of investment income. Investment income was \$20,000 and \$79,000 for the quarters ended June 30, 2010 and 2009, respectively. The change was primarily due to sublease income of \$20,000 related to an operating lease in Ohio that expired in 2009 and a decrease in interest rates between periods. Also included in the three month periods ended June 30, 2010 and 2009, is interest expense of \$5,000 and \$6,000, respectively, which resulted from a third party note for a 36 month Microsoft license subscription.

Other income, net, consists of \$56,000 investment income and \$12,000 interest expense for the six month period ended June 30, 2010. For the same period in 2009, Other income, net consists of \$147,000 investment income and \$6,000 interest expense. Included in 2009 investment income is sublease income of \$40,000. In the second quarter of 2009 we also recognized \$36,000 of investment income related to an e-Prescribing project which was not generally released and was discontinued by customer request. The remaining variance is due to a decrease in interest rates between periods.

Provision for Income Taxes

The Provision for income taxes was \$90,000 and \$26,000 for the three month period ended June 30, 2010 and 2009, respectively and \$138,000 and \$46,000 for the six month period ended June 30, 2010 and 2009, respectively. The operating losses incurred by the Company's U.S. operations and the resulting net operating losses for U.S. Federal tax purposes are subject to a \$112,348,000 reserve due to the historical uncertainty of future taxable income. Our 2010 provision for the six month period ended June 30, 2010, of \$138,000 consists of taxes on our U.S. operations totaling \$53,000, and Canadian operation totaling \$69,000, and a small amount of state taxes based on gross revenues. The 2009 provision for income tax of \$46,000 consisted of taxes on our Canadian operation totaling \$96,000, a small amount of state taxes based on gross revenues and a \$56,000 refund for historical U.S. tax credits.

There were no penalty-related charges to selling, general and administrative expenses accrued or recognized for the same comparative periods. Additionally, we have not taken a tax position that would have a material effect on the financial statements or the effective tax rate for the three and six month periods ended June 30, 2010.

The Company previously recorded a \$327,000 tax contingency liability related to tax year 2004 for its Canadian operations. That contingency remains unchanged except for currency translation adjustments. As of June 30, 2010, the gross amount of our unrecognized tax benefits, inclusive of the \$327,000 tax liability and \$50,000 in other uncertain positions in 2008, was approximately \$440,000. Included in this balance are tax positions which, if recognized, would impact our effective tax rate.

As indicated earlier, the operating losses incurred by our U.S. operations and the resulting net operating losses for U.S. Federal tax purposes are subject to a reserve. Significant judgment is required in determining any reserve recorded against the deferred tax asset. In assessing the need for a reserve, we consider all available evidence, including past operating results, estimates of future taxable income, and the feasibility of tax planning strategies.

If the facts and circumstances on which our estimates and assumptions are based were to change, thereby impacting the likelihood of realizing the deferred tax assets, we would have to apply judgment to determine the amount of reserve no longer required. Given our current income position and our expectation of continued income in future periods, we are currently in the process of evaluating our ability to utilize all or a portion of our tax reserve. Our ability to utilize all or a part of this reserve could have a significant positive impact on operating results in the period that it becomes more likely than not that certain of our deferred tax assets will be realized. Additionally, deferred tax assets may be limited in whole or in part by Internal Revenue Code Section 382. As a result, our ability to fully utilize

the deferred tax assets, including net operating loss carry forwards, against future taxable income may be limited.

Table of Contents***Net Income***

The Net income for the second quarter of 2010 of \$1,501,000 reflects the achievement of profitability for the second consecutive quarter, and is an improvement of \$3,426,000 compared to the net loss of \$1,925,000 for the same period last year. The improvement in Net income resulted from higher Gross profit, due to increased revenue and lower Cost of revenues, combined with lower R&D and SG&A expenses, as discussed above. Specifically, these expenses decreased due primarily to reductions in average headcount and other costs related to our wind down of the e-Prescribing business.

Liquidity and Capital Resources***Overview***

Based on our performance over the last four quarters and current expectations, we believe our cash and cash equivalents, and cash generated from operations, will satisfy our working capital needs, capital expenditures, investment requirements, contractual obligations, commitments, future customer financings, and other liquidity requirements associated with our operations through at least the next twelve months. We plan for and measure our liquidity and capital resources through an annual budgeting process. At June 30, 2010, our cash and cash equivalents totaled \$17,477,000 and our debt was \$250,000. Our debt consists of a note related to a three year subscription for Microsoft software licenses that is paid on a monthly basis at approximately \$12,000 per month.

We operate two distinct business segments which are in different stages of their life cycle. We expect our Email Encryption segment to remain profitable with revenue growth at approximately 25% for the full year 2010 as compared to 2009. Our e-Prescribing segment was generating significant losses when we announced in 2009 a plan to wind down this business during 2010. We expect the e-Prescribing business to be slightly profitable in 2010 and we expect to exit this business by December 31, 2010.

For the three month period ended June 30, 2010, we achieved our second consecutive quarter of profitability. Cash and cash equivalents at June 30, 2010, were \$17,477,000, an improvement of \$4,190,000 from the December 31, 2009, balance. This improvement was primarily driven by cost savings generated by the wind down of our e-Prescribing business and continued growth in the Email Encryption business. In addition, cash collections in our Email Encryption business grew while our accounts payable and accrued expenses remained relatively flat. We expect this trend to continue in the foreseeable future, and believe a significant portion of our spending is discretionary and flexible and that we have the ability to adjust overall cash spending to react, as needed, to any shortfalls in projected cash.

Impact of Current Economic Environment

With the likely continuation of constraints in the capital markets, we expect access to capital to remain somewhat restricted over the next twelve months. Although we anticipate funding our operations internally, if we are unable to do so, our ability to raise capital at costs that are similar to offerings under historic market conditions could be limited.

Sources and Uses of Cash Summary

| | Six Months Ended June 30, | |
|---|----------------------------------|-------------|
| | 2010 | 2009 |
| Net cash provided by (used in) operations | \$4,421,000 | \$(239,000) |
| Net cash used in investing activities | \$ (638,000) | \$(512,000) |
| Net cash provided by financing activities | \$ 407,000 | \$ |

As noted above, our improvement in cash provided by operations results primarily from the cost savings generated by the wind down of our e-Prescribing business, combined with growth in cash collections from our Email Encryption business and relatively flat expenses.

Related to our investing activities in the first six months of 2010, we utilized \$663,000 to purchase computing equipment primarily to satisfy customer contracts. Approximately 48% of these capital purchases were for computer servers for our Email Encryption segment, which are required to deliver our *ZixGateway*SM services. These purchases were partially offset by a \$25,000 cash inflow from proceeds from the sales of maturing marketable securities. In the first six months of 2009, we utilized \$515,000 to purchase computing equipment, of which 60% was for computer servers for our Email Encryption segment.

Cash provided from financing activities in the first six months of 2010 resulted from the exercise of stock options, which was partially offset by \$62,000 used to fund a small promissory note associated with computer software licenses. There were no such activities in the first six months of 2009. Prior to the fourth quarter of 2007 we used a significant amount of cash to fund debt obligations. We do not expect significant funding obligations in the immediate foreseeable future.

Table of Contents**Liquidity Summary**

The continued growth in our Email Encryption business and the wind down of our e-Prescribing business have driven a significant financial improvement for our Company and are reflected in our financial position for the six month period ended June 30, 2010. Based on our first six months operating results and current 2010 budget plans, we believe we have adequate resources and liquidity to sustain operations for the next twelve months. Management believes that raising capital by issuing new shares of common stock is not attractive at the current price of the Company's common stock. If we were to experience an unanticipated need for cash, we would first utilize our existing cash resources and would also consider altering our business plan to augment our cash flow position through cost reduction measures or other actions. There can be no assurance, however, that we would be successful in carrying out any of these measures if they become necessary.

Options and Warrants of ZixCorp Common Stock

We have significant warrants and options outstanding that are currently vested. There is no assurance that any of these options and warrants will be exercised; therefore, the extent of future cash from additional warrant and option exercises is not certain. The following table summarizes the warrants and options that were outstanding as of June 30, 2010. The vested shares are a subset of the outstanding shares. The value of the shares is the number of shares multiplied by the exercise price for each share.

Summary of Outstanding Options and Warrants
Vested

| Exercise Price Range | Outstanding | Total Value Outstanding | (included in Outstanding) | Total Value of Vested |
|-----------------------------|--------------------|--------------------------------|----------------------------------|------------------------------|
| \$1.11 - \$1.99 | 6,931,619 | \$ 10,616,000 | 6,449,559 | \$ 9,867,000 |
| \$2.00 - \$3.49 | 5,287,527 | 15,430,000 | 4,878,652 | 14,565,000 |
| \$3.50 - \$4.99 | 3,218,888 | 14,319,000 | 3,013,181 | 13,342,000 |
| \$5.00 - \$5.99 | 549,260 | 2,792,000 | 549,260 | 2,792,000 |
| \$6.00 - \$8.99 | 734,316 | 4,741,000 | 734,316 | 4,741,000 |
| \$9.00 - \$19.99 | 890,381 | 9,727,000 | 890,381 | 9,727,000 |
| \$20.00 - \$37.63 | 43,500 | 1,028,000 | 43,500 | 1,028,000 |
| Total | 17,655,491 | \$ 58,653,000 | 16,558,849 | \$ 56,062,000 |

Off-Balance Sheet Arrangements

None.

Contractual Obligations, Contingent Liabilities and Commitments

A summary of our fixed contractual obligations and commitments at June 30, 2010, is as follows:

| | Payments Due by Period | | | |
|---------------------------------|-------------------------------|---------------|------------------------|-----------------------|
| | Total | 1 Year | Years 2 & 3 | Beyond 3 Years |
| Operating leases | \$ 4,287,000 | \$ 1,219,000 | \$ 1,959,000 | \$ 1,109,000 |
| Debt (long-term and short-term) | 271,000 | 147,000 | 124,000 | |
| Total | \$ 4,558,000 | \$ 1,366,000 | \$ 2,083,000 | \$ 1,109,000 |

We did not enter into any other material, non cancelable purchase commitments during the three month period ended June 30, 2010.

We have severance agreements with certain employees which would require the Company to pay approximately \$1,770,000 if all such employees separated from employment with our Company in certain circumstances, including a

Change of Control or termination without Cause, as defined in the severance agreements.

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We have no material changes to the disclosure on this matter made in our Annual Report on Form 10-K for the year ended December 31, 2009.

ITEM 4. CONTROLS AND PROCEDURES

The Company, under the supervision and with the participation of its management, including the Chief Executive Officer and the Chief Financial Officer, evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of June 30, 2010.

Changes in Internal Controls over Financial Reporting

During the three month period ended June 30, 2010, there have been no changes in our internal control over financial reporting that have materially affected or are reasonably likely to materially affect internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1. Legal Proceedings

See Note 8 to the Condensed Consolidated Financial Statements set forth in this Form 10-Q.

ITEM 1A. Risk Factors

See Part I, Item 1A, Risk Factors, of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2009. There have been no material changes in our risk factors from those disclosed in such Annual Report on Form 10-K. The risk factors in our Form 10-K should be read in conjunction with the considerations set forth above in Management's Discussion and Analysis of Financial Condition and Results of Operations and in Management's Discussion and Analysis of Financial Condition and Results of Operations set forth in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009.

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

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. *(Removed and Reserved)*

ITEM 5. OTHER INFORMATION

None.

Table of Contents

ITEM 6. EXHIBITS

a. Exhibits

The following is a list of exhibits filed as part of this Quarterly Report on Form 10-Q:

| Exhibit No. | Description of Exhibits |
|--------------------|--|
| 3.1 | Restated Articles of Incorporation of Zix Corporation, as filed with the Texas Secretary of State on November 10, 2005. Filed as Exhibit 3.1 to Zix Corporation's Annual Report on Form 10-K for the year ended December 31, 2005, and incorporated herein by reference. |
| 3.2 | Amended and Restated Bylaws of Zix Corporation, dated February 4, 2009. Filed as Exhibit 3.1 to Zix Corporation's Current Report on Form 8-K, dated February 10, 2009, and incorporated herein by reference. |
| 10.1* | Form of Zix Corporation Outside Director Stock Option Agreement. |
| 10.2* | Form of Zix Corporation Employee Stock Option Agreement. |
| 31.1* | Certification of Richard D. Spurr, President and Chief Executive Officer of the Company, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2* | Certification of Susan K. Conner, Chief Financial Officer of the Company, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1** | Certification of Richard D. Spurr, President and Chief Executive Officer of the Company, and Susan K. Conner, Chief Financial Officer of the Company, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

* Filed herewith.

** Furnished
herewith.

Table of Contents

SIGNATURES

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

ZIX CORPORATION

Date: August 9, 2010

By: /s/ Susan K. Conner
Susan K. Conner
Chief Financial Officer

21