

ZIX CORP
Form 10-Q
November 05, 2010

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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 September 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 November 2, 2010 |
|---|--|
| Common Stock, par value \$0.01 per share | 64,692,332 |

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ZIX CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS

| | September 30, 2010 (unaudited) | December 31, 2009 |
|--|---|------------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 19,571,000 | \$ 13,287,000 |
| Marketable securities | | 25,000 |
| Receivables, net | 817,000 | 760,000 |
| Prepaid and other current assets | 923,000 | 1,142,000 |
| | | |
| Total current assets | 21,311,000 | 15,214,000 |
| Property and equipment, net | 2,282,000 | 2,137,000 |
| Goodwill | 2,161,000 | 2,161,000 |
| Other assets | 133,000 | 236,000 |
| | | |
| Total assets | \$ 25,887,000 | \$ 19,748,000 |
| LIABILITIES AND STOCKHOLDERS EQUITY (DEFICIT) | | |
| Current liabilities: | | |
| Accounts payable | \$ 414,000 | \$ 769,000 |
| Accrued expenses | 2,421,000 | 3,124,000 |
| Deferred revenue | 16,378,000 | 14,478,000 |
| License subscription note payable | 134,000 | 126,000 |
| | | |
| Total current liabilities | 19,347,000 | 18,497,000 |
| Long-term liabilities: | | |
| Deferred revenue | 1,716,000 | 2,821,000 |
| License subscription note payable | 84,000 | 186,000 |
| Deferred rent | 180,000 | 233,000 |
| | | |
| Total long-term liabilities | 1,980,000 | 3,240,000 |
| | | |
| Total liabilities | 21,327,000 | 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; 66,696,410 issued and 64,369,229 outstanding in 2010 and 66,053,772 issued and 63,726,591 outstanding in 2009 | 667,000 | 661,000 |
| Additional paid-in capital | 339,914,000 | 337,352,000 |
| Treasury stock, at cost; 2,327,181 common shares in 2010 and 2009 | (11,507,000) | (11,507,000) |
| Accumulated deficit | (324,514,000) | (328,495,000) |
| | | |
| Total stockholders' equity (deficit) | 4,560,000 | (1,989,000) |

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| | | |
|--|---------------|---------------|
| Total liabilities and stockholders' equity (deficit) | \$ 25,887,000 | \$ 19,748,000 |
|--|---------------|---------------|

See notes to condensed consolidated financial statements.

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ZIX CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

| | Three Months Ended September | | Nine Months Ended September | |
|--|-------------------------------------|--------------|------------------------------------|----------------|
| | 30, | | 30, | |
| | 2010 | 2009 | 2010 | 2009 |
| Revenues | \$ 9,040,000 | \$ 7,835,000 | \$ 26,371,000 | \$ 22,462,000 |
| Cost of revenues | 1,888,000 | 2,249,000 | 5,714,000 | 7,088,000 |
| Gross profit | 7,152,000 | 5,586,000 | 20,657,000 | 15,374,000 |
| Operating expenses: | | | | |
| Research and development | 1,317,000 | 1,760,000 | 4,072,000 | 5,238,000 |
| Selling, general and administrative | 4,086,000 | 4,557,000 | 12,529,000 | 14,429,000 |
| Total operating expenses | 5,403,000 | 6,317,000 | 16,601,000 | 19,667,000 |
| Operating income (loss) | 1,749,000 | (731,000) | 4,056,000 | (4,293,000) |
| Other income, net | 22,000 | 35,000 | 66,000 | 176,000 |
| Income (loss) before income taxes | 1,771,000 | (696,000) | 4,122,000 | (4,117,000) |
| Provision for income tax (expense) benefit | (3,000) | 39,000 | (141,000) | (7,000) |
| Net income (loss) | \$ 1,768,000 | \$ (657,000) | \$ 3,981,000 | \$ (4,124,000) |
| Basic income (loss) per common share | \$ 0.03 | \$ (0.01) | \$ 0.06 | \$ (0.07) |
| Diluted income (loss) per common share | \$ 0.03 | \$ (0.01) | \$ 0.06 | \$ (0.07) |
| Basic weighted average common shares outstanding | 64,148,452 | 63,367,037 | 63,973,102 | 63,335,508 |
| Diluted weighted average common shares outstanding | 66,646,541 | 63,367,037 | 66,208,508 | 63,335,508 |

See notes to condensed consolidated financial statements.

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ZIX CORPORATION
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY (DEFICIT)
(Unaudited)

| | Common Stock | | Stockholders Additional Paid-In | Equity (Deficit) 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 | 642,638 | 6,000 | 1,026,000 | | | 1,032,000 |
| Employee stock-based compensation costs | | | 1,506,000 | | | 1,506,000 |
| Non-employee stock-based compensation costs | | | 30,000 | | | 30,000 |
| Net income | | | | | 3,981,000 | 3,981,000 |
| Balance, September 30, 2010 | 66,696,410 | \$ 667,000 | \$ 339,914,000 | \$ (11,507,000) | \$ (324,514,000) | \$ 4,560,000 |

See notes to condensed consolidated financial statements.

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ZIX CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

| | Nine Months Ended September | |
|---|------------------------------------|----------------|
| | 30, | |
| | 2010 | 2009 |
| Operating activities: | | |
| Net income (loss) | \$ 3,981,000 | \$ (4,124,000) |
| Non-cash items in net income (loss): | | |
| Depreciation and amortization | 1,047,000 | 987,000 |
| Employee stock-based compensation costs | 1,506,000 | 2,473,000 |
| Non-employee stock-based compensation costs | 30,000 | 24,000 |
| Changes in deferred taxes | 6,000 | 5,000 |
| Changes in operating assets and liabilities: | | |
| Receivables | (57,000) | (205,000) |
| Prepaid and other assets | 330,000 | 256,000 |
| Accounts payable | (411,000) | 168,000 |
| Deferred revenue | 795,000 | (258,000) |
| Accrued expenses and other liabilities | (756,000) | 357,000 |
| Net cash provided by (used in) operating activities | 6,471,000 | (317,000) |
| Investing activities: | | |
| Purchases of property and equipment | (1,150,000) | (852,000) |
| Sales of marketable securities | 25,000 | |
| Restricted cash and marketable securities, net | | 3,000 |
| Net cash used in investing activities | (1,125,000) | (849,000) |
| Financing activities: | | |
| Proceeds from exercise of stock options | 1,032,000 | 13,000 |
| Proceeds from exercise of warrants | | 339,000 |
| Payment of license subscription note payable | (94,000) | (39,000) |
| Net cash provided by financing activities | 938,000 | 313,000 |
| Increase (decrease) in cash and cash equivalents | 6,284,000 | (853,000) |
| Cash and cash equivalents, beginning of period | 13,287,000 | 13,245,000 |
| Cash and cash equivalents, end of period | \$ 19,571,000 | \$ 12,392,000 |

See notes to condensed consolidated financial statements.

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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 nine month periods ended September 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 beyond 2010:

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 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 2015 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 continue 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 September 30, 2010 and 2009.

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| Three Months Ended September 30, 2010 | Email Encryption | e-Prescribing | Corporate | Total |
|---|-----------------------------|----------------------|------------------|--------------|
| Revenues | \$ 8,548,000 | \$ 492,000 | \$ | \$ 9,040,000 |
| Cost of revenues | 1,662,000 | 226,000 | | 1,888,000 |
| Gross profit | 6,886,000 | 266,000 | | 7,152,000 |
| Direct expenses | 3,607,000 | 116,000 | | 3,723,000 |
| Segment contribution | 3,279,000 | 150,000 | | 3,429,000 |
| Unallocated (expense) income | | | | |
| General and administrative expense | | | (1,680,000) | (1,680,000) |
| Other income, net | | | 22,000 | 22,000 |
| Total unallocated (expense) income | | | (1,658,000) | (1,658,000) |
| Income (loss) before provision for income taxes | \$ 3,279,000 | \$ 150,000 | \$ (1,658,000) | \$ 1,771,000 |

| Three Months Ended September 30, 2009 | Email Encryption | e-Prescribing | Corporate | Total |
|---|-----------------------------|----------------------|------------------|--------------|
| Revenues | \$ 6,685,000 | \$ 1,150,000 | \$ | \$ 7,835,000 |
| Cost of revenues | 1,179,000 | 1,070,000 | | 2,249,000 |
| Gross profit | 5,506,000 | 80,000 | | 5,586,000 |
| Direct expenses | 2,882,000 | 1,460,000 | | 4,342,000 |
| Segment contribution (loss) | 2,624,000 | (1,380,000) | | 1,244,000 |
| Unallocated (expense) income | | | | |
| General and administrative expense | | | (1,975,000) | (1,975,000) |
| Other income, net | | | 35,000 | 35,000 |
| Total unallocated (expense) income | | | (1,940,000) | (1,940,000) |
| Income (loss) before provision for income taxes | \$ 2,624,000 | \$ (1,380,000) | \$ (1,940,000) | \$ (696,000) |

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

| Nine Months Ended September 30, 2010 | Email Encryption | e-Prescribing | Corporate | Total |
|---|-----------------------------|----------------------|------------------|---------------|
| Revenues | \$ 24,221,000 | \$ 2,150,000 | \$ | \$ 26,371,000 |
| Cost of revenues | 4,734,000 | 980,000 | | 5,714,000 |
| Gross profit | 19,487,000 | 1,170,000 | | 20,657,000 |
| Direct expenses | 11,016,000 | 542,000 | | 11,558,000 |

| | | | | |
|---|--------------|------------|----------------|--------------|
| Segment contribution | 8,471,000 | 628,000 | | 9,099,000 |
| Unallocated (expense) income | | | | |
| General and administrative expense | | | (5,043,000) | (5,043,000) |
| Other income, net | | | 66,000 | 66,000 |
| Total unallocated (expense) income | | | (4,977,000) | (4,977,000) |
| Income (loss) before provision for income taxes | \$ 8,471,000 | \$ 628,000 | \$ (4,977,000) | \$ 4,122,000 |

| Nine Months Ended September 30, 2009 | Email | | | Total |
|---|---------------|----------------|----------------|----------------|
| | Encryption | e-Prescribing | Corporate | |
| Revenues | \$ 19,306,000 | \$ 3,156,000 | \$ | \$ 22,462,000 |
| Cost of revenues | 3,280,000 | 3,808,000 | | 7,088,000 |
| Gross profit | 16,026,000 | (652,000) | | 15,374,000 |
| Direct expenses | 8,617,000 | 5,054,000 | | 13,671,000 |
| Segment contribution (loss) | 7,409,000 | (5,706,000) | | 1,703,000 |
| Unallocated (expense) income | | | | |
| General and administrative expense | | | (5,996,000) | (5,996,000) |
| Other income, net | | | 176,000 | 176,000 |
| Total unallocated (expense) income | | | (5,820,000) | (5,820,000) |
| Income (loss) before provision for income taxes | \$ 7,409,000 | \$ (5,706,000) | \$ (5,820,000) | \$ (4,117,000) |

Depreciation and amortization expense:

The following table shows depreciation and amortization expense by segment.

| | Nine Months Ended September 30, | |
|----------------------------|------------------------------------|------------|
| | 2010 | 2009 |
| Email Encryption | \$ 819,000 | \$ 596,000 |
| e-Prescribing | 109,000 | 259,000 |
| Unallocated | 119,000 | 132,000 |
| Total depreciation expense | \$ 1,047,000 | \$ 987,000 |

Table of Contents**Allocated costs:**

For the periods presented we allocated expenses to our segment businesses. These include expenses related to occupancy, information technology and commercial insurance and are generally allocated to the business segments based on direct headcount. Additionally, we allocate expenses incurred by our customer service, network operations, quality assurance, research and development and marketing departments which are generally allocated based on percent of effort. After we wind down the e-Prescribing business, the Email Encryption Segment will absorb the remaining portion of ongoing overhead costs that otherwise would have been allocated to the e-Prescribing segment. We estimate that during 2011, after the e-Prescribing segment is discontinued, the Email Encryption business will absorb between \$600,000 to \$700,000 in reallocated overhead cost, which is approximately \$150,000 to \$175,000 on a quarterly basis. Of this amount, approximately 70% will be recorded to Cost of revenues, and the remaining 30% spread between Research and development and Selling, general and administrative expense.

The wind down of the e-Prescribing business is progressing well and we expect to complete the wind down as planned by the end of 2010.

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.

| | September 30, 2010 | December 31, 2009 |
|----------------------|-------------------------------|------------------------------|
| Total assets: | | |
| Email Encryption | \$ 3,997,000 | \$ 3,781,000 |
| e-Prescribing | 220,000 | 416,000 |
| Corporate | 21,670,000 | 15,551,000 |
| Total assets | \$ 25,887,000 | \$ 19,748,000 |

4. Stock Options and Stock-based Employee Compensation

As of September 30, 2010, there were 8,906,325 options outstanding and 1,384,414 available for grant. Of this amount, 1,142,391 options were available for grant to employees and 242,023 were available for grant to the Company's directors. For the three and nine month periods ended September 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 September 30, 2010 | Nine Months Ended September 30, 2010 |
|-------------------------------------|--|---|
| Cost of revenues | \$ 49,000 | \$ 150,000 |
| Research and development | 50,000 | 148,000 |
| Selling, general and administrative | 431,000 | 1,208,000 |
| Stock-based compensation expense | \$ 530,000 | \$ 1,506,000 |

There were 333,542 and 642,638 stock options exercised for the three and nine month periods ended September 30, 2010. There were 7,492 stock options exercised for the three and nine month periods ended September 30, 2009. The excess tax benefit recorded in the three month period related to the 333,542 options exercises was \$2,100. The excess tax deficiency recorded in the nine month period ended September 30, 2010, related to the 642,638 options exercised was \$28,000. A deferred tax asset totaling \$477,000 and \$799,000, resulting from stock-based compensation expense relating to the Company's U.S. operations, was recorded for the nine month periods ended September 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 September 30, 2010, there was \$1,075,000 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 0.93 years.

Table of Contents**Stock Option Activity**

The following is a summary of all stock option transactions for the three month period ended September 30, 2010:

| | Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (Yrs) | Aggregate Intrinsic Value |
|---|-----------|--|--|---------------------------------|
| Outstanding at June 30, 2010 | 9,648,929 | \$ 4.21 | | |
| Granted at market price | 2,000 | \$ 2.28 | | |
| Cancelled or expired | (411,062) | \$ 5.74 | | |
| Exercised | (333,542) | \$ 1.70 | | |
| Outstanding at September 30, 2010 | 8,906,325 | \$ 4.23 | 5.36 | \$ 3,485,000 |
| Options exercisable at September 30, 2010 | 8,107,663 | \$ 4.43 | 5.02 | \$ 2,781,000 |

At September 30, 2010, we had 3,098,556 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:

| | Nine Months Ended September 30, | |
|--|------------------------------------|------------|
| | 2010 | 2009 |
| Cash paid for interest | \$ 17,000 | \$ 13,000 |
| Cash income tax payments | \$ 217,000 | \$ 203,000 |
| Non-cash investing and financing activities: | | |
| Assets sold to customers as part of their subscription service | \$ 14,000 | \$ 2,000 |
| Payables related to purchases of fixed assets | \$ 56,000 | \$ 233,000 |
| Issuance of license subscription note payable | \$ | \$ 390,000 |
| Amounts reclassified from Notes payable to Accounts payable | \$ | \$ 19,000 |

6. Receivables, net

| | September 30, 2010 | December 31, 2009 |
|---|--------------------------|-------------------------|
| Receivables | \$ 837,000 | \$ 786,000 |
| Allowance for returns and doubtful accounts | (20,000) | (26,000) |
| Note receivable | 484,000 | 484,000 |
| Allowance for note receivable | (484,000) | (484,000) |
| Receivables, net | \$ 817,000 | \$ 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.

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 nine month periods ended September 30, 2010 and 2009, are as follows:

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| | Three Months ended September 30, | | Nine Months ended September 30, | |
|-------------------------------------|---|--------------|--|----------------|
| | 2010 | 2009 | 2010 | 2009 |
| Net income (loss) | \$ 1,768,000 | \$ (657,000) | \$ 3,981,000 | \$ (4,124,000) |
| Basic weighted average shares | 64,148,452 | 63,367,037 | 63,973,102 | 63,335,508 |
| Effect of dilutive securities: | | | | |
| Employee and director stock options | 861,059 | | 786,136 | |
| Warrants | 1,637,030 | | 1,449,270 | |
| Potential dilutive common shares | 66,646,541 | 63,367,037 | 66,208,508 | 63,335,508 |
| Net earnings (loss) per share | | | | |
| Basic | \$ 0.03 | \$ (0.01) | \$ 0.06 | \$ (0.07) |
| Diluted | \$ 0.03 | \$ (0.01) | \$ 0.06 | \$ (0.07) |

During the three and nine month periods ended September 30, 2010, weighted average shares related to certain stock options of 7,007,729 and 7,317,353 respectively, were excluded from the calculation of diluted earnings per share because the stock options were anti-dilutive. Anti-dilutive warrants of 145,853 in both the three and nine month periods ended September 30, 2010, were also excluded from the calculation. For the three and nine month periods ended September 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 nine month periods ended September 30, 2009, was 9,654,547 for stock options and 10,052,640 for warrants.

8. Commitments and contingencies

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

| | Payments Due by Period | | | Beyond 3 Years |
|-----------------------------------|-------------------------------|---------------|------------------------|-----------------------|
| | Total | 1 Year | Years 2 & 3 | |
| Operating leases | \$ 3,954,000 | \$ 1,178,000 | \$ 1,889,000 | \$ 887,000 |
| License subscription note payable | 218,000 | 134,000 | 84,000 | |
| Total cash obligations | 4,172,000 | 1,312,000 | 1,973,000 | 887,000 |
| Interest on obligations | 16,000 | 14,000 | 2,000 | |
| Total | \$ 4,188,000 | \$ 1,326,000 | \$ 1,975,000 | \$ 887,000 |

We have not entered into any material, non-cancelable purchase commitments at September 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 Email Encryption Service. More than 1,200 hospitals and over 1,400 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 23 million member 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.

Results of Operations***Third Quarter 2010 Summary of Operations
Financial***

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Revenue for the quarter ended September 30, 2010, was \$9,040,000 compared with \$7,835,000 for the same period in 2009 representing a 15% increase.

Gross profit for the quarter ended September 30, 2010, was \$7,152,000 or 79% of revenues compared with \$5,586,000 or 71% of revenues for the comparable period in 2009.

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Email Encryption gross profit was \$6,886,000 or 81% of revenues compared with \$5,506,000 or 82% of revenues for the comparable period in 2009. The slight decline in gross margin percentage is due to the increase in allocated costs previously absorbed by the e-Prescribing segment.

e-Prescribing gross profit was \$266,000 or 54% of revenues compared with gross profit of \$80,000 or 7% of revenues for the comparable period in 2009.

Net income for the quarter ended September 30, 2010, was \$1,768,000 compared with a net loss of \$657,000 for the comparable period in 2009. Included in net income for the quarter ended September 30, 2010, was approximately \$176,000 of non recurring severance costs related primarily to the departure of our Chief Financial Officer.

Ending cash and cash equivalents were \$19,571,000 on September 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 September 30, 2010, were \$2,201,000. The Email Encryption backlog was \$46,583,000 at September 30, 2010.

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 reported in our October 25, 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 | | Nine Months Ended | | 9-month | |
|------------------|--------------------|--------------------|------------------------|-------|--------------------|--------------------|------------------------|-------|
| | September 30, 2010 | September 30, 2009 | Variance 2010 vs. 2009 | | September 30, 2010 | September 30, 2009 | Variance 2010 vs. 2009 | |
| | | | \$ | % | | | \$ | % |
| Email Encryption | \$ 8,548,000 | \$ 6,685,000 | \$ 1,863,000 | 28% | \$ 24,221,000 | \$ 19,306,000 | \$ 4,915,000 | 25% |
| e-Prescribing | 492,000 | 1,150,000 | (658,000) | (57%) | 2,150,000 | 3,156,000 | (1,006,000) | (32%) |
| Total revenues | \$ 9,040,000 | \$ 7,835,000 | \$ 1,205,000 | 15% | \$ 26,371,000 | \$ 22,462,000 | \$ 3,909,000 | 17% |

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. The decrease in e-Prescribing revenue is due to the ongoing wind down of the e-Prescribing business. We expect 2010 e-Prescribing revenue to be between \$2.5 and \$2.6 million.

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 represents the fees that our customers are obliged to pay us over the terms of their services agreements, which fees we expect to amortize into revenue as we perform the services. 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.

As of September 30, 2010, Email Encryption backlog was \$46,583,000 and we expect approximately 57% of the backlog to be recognized as revenue during the next twelve months. As of September 30, 2010, the Email Encryption backlog was comprised of the following elements: \$17,755,000 of deferred revenue that has been billed and paid,

\$4,175,000 billed but unpaid, and approximately \$24,653,000 of unbilled backlog relating primarily to the second and third years of multi-year contracts.

Email Encryption Orders Total orders for Email Encryption were \$9,686,000 and \$6,499,000 for the three month periods ended September 30, 2010 and 2009, respectively. 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 \$2,201,000 and \$1,314,000 for the three month periods ended September 30, 2010 and 2009, respectively.

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e-Prescribing As of September 30, 2010, our e-Prescribing backlog was \$354,000, which we expect to recognize as revenue in 2010. This backlog was comprised of \$339,000 of deferred revenue that has been billed and paid and \$15,000 billed but unpaid. This backlog includes revenue from approximately 1,350 actively writing prescribers with subscriptions through our December 2010 wind down 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 | | 3-month | | Nine Months Ended | | 9-month Variance | |
|------------------------|--------------------|--------------|---------------|-------|-------------------|--------------|------------------|-------|
| | September 30, | | 2010 vs. 2009 | | September 30, | | 2010 vs. 2009 | |
| | 2010 | 2009 | \$ | % | 2010 | 2009 | \$ | % |
| Email | | | | | | | | |
| Encryption | \$ 1,662,000 | \$ 1,179,000 | \$ 483,000 | 41% | \$ 4,734,000 | \$ 3,280,000 | \$ 1,454,000 | 44% |
| e-Prescribing | 226,000 | 1,070,000 | (844,000) | (79%) | 980,000 | 3,808,000 | (2,828,000) | (74%) |
| Total cost of revenues | \$ 1,888,000 | \$ 2,249,000 | \$ (361,000) | (16%) | \$ 5,714,000 | \$ 7,088,000 | \$ (1,374,000) | (19%) |

Due to the wind down of the e-Prescribing business, we have eliminated headcount and expenses for activities relating to recruiting new prescribers and deploying new service for both periods presented. Additionally, due to reduced e-Prescribing business activity in 2010, that business is absorbing a smaller portion of the allocated costs compared to the same periods last year. Of the \$226,000 third quarter 2010 Cost of revenues, approximately \$120,000 is allocated cost that will remain after the conclusion of the wind down and will therefore be absorbed by Email Encryption in 2011. Conversely, the Email Encryption business has grown and is absorbing more of the allocated costs compared to the same periods last year. The increases in Email Encryption Cost of revenues for both periods presented resulted primarily from increases in allocated costs.

For both the three and nine month periods ended September 30, 2010, the consolidated Cost of revenues improvement reflected the impact of expense reductions resulting from the wind down of our e-Prescribing business. For the three month period ended September 30, 2010 the Cost of revenues improvement compared to the same period last year resulted primarily from (i) a \$215,000 decrease in salary and benefits for individuals performing deployment activities due primarily to a decrease in average headcount in the e-Prescribing product line, (ii) a \$40,000 decrease in e-Prescribing device costs, (iii) a \$32,000 decrease in travel costs, and (iv) a \$99,000 decrease in stock-based compensation expense. These reductions were partially offset by a \$25,000 net increase in other various non-people costs.

For the nine month period ended September 30, 2010, the Cost of revenues improvement compared to the same period last year resulted primarily from (i) an \$845,000 decrease in salary and benefits for individuals performing deployment activities due to a decrease in average headcount primarily in the e-Prescribing product line, (ii) a \$228,000 decrease in e-Prescribing device costs, (iii) a \$122,000 decrease in travel costs, (iv) a \$182,000 decrease in stock-based compensation expense. These reductions were partially offset by a \$3,000 net increase in other various non-people costs.

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 | | Nine Months Ended | | 9-month | |
|--------------------------------|--------------------|--------------|--------------|-------|-------------------|--------------|----------------|-------|
| | September 30, | | Variance | | September 30, | | Variance | |
| | 2010 | 2009 | \$ | % | 2010 | 2009 | \$ | % |
| Email | | | | | | | | |
| Encryption | \$ 1,261,000 | \$ 886,000 | \$ 375,000 | 42% | \$ 3,818,000 | \$ 2,510,000 | \$ 1,308,000 | 52% |
| e-Prescribing | 56,000 | 874,000 | (818,000) | (94%) | 254,000 | 2,728,000 | (2,474,000) | (91%) |
| Total Research and development | \$ 1,317,000 | \$ 1,760,000 | \$ (443,000) | (25%) | \$ 4,072,000 | \$ 5,238,000 | \$ (1,166,000) | (22%) |

Research and development expenses (R&D) 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. For both the three and nine month periods ended September 30, 2010, compared to the same periods last year, the percentage of shared research and development resources allocated to the Email Encryption business increased and the e-Prescribing business decreased due to the reduced activity in e-Prescribing resulting from the wind down of that business.

For both the three and nine month periods ended September 30, 2010, the consolidated Research and development expense improvement compared to the same periods last year, reflected the impact of expense reductions resulting from the wind down of our e-Prescribing business. For the three month period ended September 30, 2010, the Research and development improvement compared to the same period last year resulted primarily from (i) a \$329,000 decrease in salary and benefits for individuals performing development activities due primarily to a decrease in average headcount in the e-Prescribing product line, (ii) a \$34,000 decrease in facility costs, and (iii) an \$80,000 decrease in stock-based compensation expense.

For the nine month period ended September 30, 2010, lower Research and development expenses compared to the same period last year resulted primarily from (i) a \$936,000 decrease in salary and benefits for individuals performing development activities due to a decrease in average headcount primarily in the e-Prescribing product line, (ii) a \$92,000 decrease in facility costs, (iii) a \$132,000 decrease in stock-based compensation expense, and (v) a \$6,000 net decrease in other various non-people costs.

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 | | Nine Months Ended | | 9-month | |
|--------------------------------|--------------------|--------------|------------|-------|-------------------|--------------|-------------|-------|
| | September 30, | | Variance | | September 30, | | Variance | |
| | 2010 | 2009 | \$ | % | 2010 | 2010 | \$ | % |
| Email | | | | | | | | |
| Encryption | | | | | | | | |
| Selling and marketing expenses | \$ 2,119,000 | \$ 1,850,000 | \$ 269,000 | 15% | \$ 6,500,000 | \$ 5,641,000 | \$ 859,000 | 15% |
| | 47,000 | 561,000 | (514,000) | (92%) | 223,000 | 2,250,000 | (2,027,000) | (90%) |

| | | | | | | | | |
|---|--------------|--------------|--------------|-------|---------------|---------------|----------------|-------|
| e-Prescribing Selling and marketing expenses | | | | | | | | |
| Corporate General and administrative expenses | 1,920,000 | 2,146,000 | (226,000) | (11%) | 5,806,000 | 6,538,000 | (732,000) | (11%) |
| Total Selling, general and administrative expenses | \$ 4,086,000 | \$ 4,557,000 | \$ (471,000) | (10)% | \$ 12,529,000 | \$ 14,429,000 | \$ (1,900,000) | (13%) |

Selling, general and administrative expenses (SG&A) consist primarily of salary, stock-based compensation, variable sales 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 September 30, 2010, increased due to (i) a \$189,000 increase in salaries and variable compensation resulting from an increase in average headcount and sales commissions resulting from higher NFYOs and, (ii) an \$80,000 increase in allocated costs for occupancy, information technology and other shared resources.

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The increase in Email Encryption selling and marketing expenses for the nine month period ended September 30, 2010 compared to the same period last year resulted primarily from (i) a \$605,000 increase in salaries and variable compensation driven primarily by higher average headcount and sales commissions resulting from higher NFYOs, and (ii) a \$254,000 increase in allocated costs due to the wind down of the e-Prescribing business for occupancy, information technology and other shared resources.

The reductions for e-Prescribing for both the three and nine month periods ended September 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 September 30, 2010, compared to the same period last year resulted from (i) a \$108,000 decrease in professional fees, primarily outside legal fees and (ii) a \$209,000 decrease in stock-based compensation expense. These decreases were partially offset by a net increase of \$91,000 in various other general and administrative expenses, primarily severance expense.

For the nine month period ended September 30, 2010, General and administrative expenses decreased primarily due to (i) a \$176,000 decrease in salary and benefit expenses attributable primarily to non-recurring severance expense in the second quarter of 2009, (ii) a \$345,000 decrease in professional fees, primarily outside legal fees, (iii) a \$302,000 decrease in stock-based compensation expense. These decreases were partially offset by a \$91,000 net increase in various other general and administrative expenses, primarily consulting.

Other Income, net

Other income, net consists primarily of investment income. Investment income was \$27,000 and \$43,000 for the quarters ended September 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 September 30, 2010 and 2009, is interest expense of \$5,000 and \$8,000, respectively, which resulted from a third party note for a 36 month Microsoft license subscription.

Other income, net, consists of \$83,000 investment income and \$17,000 interest expense for the nine month period ended September 30, 2010. For the same period in 2009, Other income, net consists of \$189,000 investment income and \$13,000 interest expense. Included in 2009 investment income is sublease income of \$59,000. 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 Tax Expense (Benefit)

The Provision for income tax expense (benefit) was \$3,000 and (\$39,000) for the three month periods ended September 30, 2010 and 2009, respectively and \$141,000 and \$7,000 for the nine month periods ended September 30, 2010 and 2009, respectively. The Company's U.S. operations historically incurred operating losses that resulted in net operating loss carry-forwards (NOLs), which potentially could reduce the Company's future taxable income for U.S. Federal tax purposes. These NOLs and other deferred tax assets are subject to a \$111,477,000 valuation allowance (NOL Reserve) due to uncertainty about whether the Company will be able to use them to offset future taxable income. Our 2010 provision of \$141,000 for the nine month period ended September 30, 2010, consists of taxes on our U.S. operations totaling \$7,000, and Canadian operation totaling \$101,000, and \$33,000 in state taxes based on gross revenues. The 2009 provision for income tax of \$7,000 consisted of taxes on our Canadian operation totaling \$129,000, a \$27,000 benefit for over-accrual of prior year state taxes based on gross revenues and a \$95,000 refund for historical U.S. tax credits.

There were no penalty-related charges to SG&A 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 nine month periods ended September 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 September 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 \$448,000. Included in this balance are tax positions which, if recognized, would impact our effective tax rate.

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We apply significant judgment in determining the amount of the NOL Reserve. In making that judgment, we consider all available facts and circumstances, including our past operating results, estimates of our future taxable income, and the feasibility of our tax planning strategies, and potential limits on the use of the NOLs. In particular, our ability to use the NOLs to reduce future taxable income for the U.S. Federal income tax purposes might be limited by section 382 of the Internal Revenue Code. We periodically reassess our judgment about the amount of the NOL Reserve as facts and circumstances change. We currently are assessing our ability to reduce the size of the NOL Reserve, principally based on our current expectations about our future taxable income. A reduction in the NOL Reserve, and the availability of the associated NOLs to reduce our taxable income for U.S. Federal income tax purposes, could have a significant positive impact on our operating results for the affected periods.

Net Income

The Net income for the third quarter of 2010 of \$1,768,000 reflects the achievement of profitability for the third consecutive quarter, and is an improvement of \$2,425,000 compared to the net loss of \$657,000 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 September 30, 2010, our cash and cash equivalents totaled \$19,571,000 and our debt was \$218,000. 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. We expect our Email Encryption segment to remain profitable with revenue growth at approximately 25% for the full year 2010. 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 September 30, 2010, we achieved our third consecutive quarter of profitability. Cash and cash equivalents at September 30, 2010, were \$19,571,000, an improvement of \$6,284,000 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.

Sources and Uses of Cash Summary

| | Nine Months Ended September 30, | |
|---|--|--------------|
| | 2010 | 2009 |
| Net cash provided by (used in) operations | \$ 6,471,000 | \$ (317,000) |
| Net cash used in investing activities | \$ (1,125,000) | \$ (849,000) |
| Net cash provided by financing activities | \$ 938,000 | \$ 313,000 |

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 nine months of 2010, we utilized \$1,150,000 primarily to purchase computing equipment. Approximately 43% of these capital purchases were for computer servers for our Email Encryption segment, which are required to deliver our *ZixGateway*[®] services. We also invested in a one time infrastructure upgrade to our network operations center. These purchases were partially offset by a \$25,000 cash inflow from proceeds from the sales of maturing marketable securities.

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In the first nine months of 2009, we utilized \$852,000 to purchase computing equipment, of which approximately 60% was for computer servers for our Email Encryption segment.

Cash provided from financing activities in the first nine months of 2010 resulted from the exercise of stock options, which was partially offset by \$94,000 used to fund a small promissory note associated with computer software licenses. Cash provided by financing activities in the third quarter of 2009 included \$339,000 resulting from the exercise of warrants and \$13,000 resulting from the exercise of stock options. These inflows were partially offset by \$39,000 payment related to the license subscription note payable.

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 nine month period ended September 30, 2010. Based on our first nine months operating results and current 2010 budget plans, we believe we have adequate resources and liquidity to sustain operations for the next twelve months. We currently have no plans to issue new shares of common stock other than with respect to outstanding options and warrants. 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 September 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 | 6,659,243 | \$ 10,215,000 | 6,305,719 | \$ 9,670,000 |
| \$2.00 - \$3.49 | 1,571,190 | 4,184,000 | 1,234,977 | 3,474,000 |
| \$3.50 - \$4.99 | 3,115,681 | 13,824,000 | 3,006,756 | 13,310,000 |
| \$5.00 - \$5.99 | 515,927 | 2,624,000 | 515,927 | 2,624,000 |
| \$6.00 - \$8.99 | 631,816 | 4,123,000 | 631,816 | 4,123,000 |
| \$9.00 - \$19.99 | 887,381 | 9,670,000 | 887,381 | 9,670,000 |
| \$20.00 - \$21.38 | 18,750 | 401,000 | 18,750 | 401,000 |
| Total | 13,399,988 | \$ 45,041,000 | 12,601,326 | \$ 43,272,000 |

Off-Balance Sheet Arrangements

None.

Contractual Obligations, Contingent Liabilities and Commitments

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

| | Payments Due by Period | | | Beyond 3 Years |
|---------------------------------|-------------------------------|---------------|------------------------|---------------------------|
| | Total | 1 Year | Years 2 & 3 | |
| Operating leases | \$ 3,954,000 | \$ 1,178,000 | \$ 1,889,000 | \$ 887,000 |
| Debt (long-term and short-term) | 234,000 | 148,000 | 86,000 | |

| | | | | |
|-------|--------------|--------------|--------------|------------|
| Total | \$ 4,188,000 | \$ 1,326,000 | \$ 1,975,000 | \$ 887,000 |
|-------|--------------|--------------|--------------|------------|

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

We have severance agreements with certain employees which would require the Company to pay approximately \$1,606,000 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.

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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

As reported in the Company's Form 8-K submission on September 2, 2010, the Company's Chief Financial Officer left the Company effective August 31, 2010, and the next day the Company's Controller was appointed Principal Accounting Officer and assumed the responsibilities of the former Chief Financial Officer for the Company's internal controls over financial disclosure. The Company, under the supervision and with the participation of its management, including the Chief Executive Officer and the Principal Accounting 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 Principal Accounting Officer concluded that the Company's disclosure controls and procedures were effective as of September 30, 2010.

Changes in Internal Controls over Financial Reporting

During the three month period ended September 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.

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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. |
| 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 Michael W. English, Principal Accounting 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 Michael W. English, Principal Accounting Officer of the Company, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

* Filed herewith.

** Furnished herewith.

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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: November 5, 2010

By: /s/ MICHAEL W. ENGLISH
Michael W. English
Principal Accounting Officer

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