SECURITIES AND EXCHANGE COMMISSION

FORM 10-Q

Quarterly report pursuant to sections 13 or 15(d)

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TUMBLEWEED COMMUNICATIONS CORP

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended March 31, 2002

Commission File Number: 000-26223

TUMBLEWEED COMMUNICATIONS CORP.

(Exact name of registrant as specified in its charter)

DELAWARE	**94-3336053**
(State of other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

**700 SAGINAW DRIVE
REDWOOD CITY, CA 94063**
(Address of principal executive offices, including zip code)

(650) 216-2000
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required 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 ☐

The number of shares of common stock outstanding as of April 30, 2002 was 30,704,059.

SPECIAL NOTE ON FORWARD-LOOKING STATEMENTS This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, which are subject to the "safe harbor" created by those sections. The forward-looking statements are based on our current expectations and projections about future events, including, but not limited to, implementing our business strategy; attracting and retaining customers; obtaining and expanding market acceptance of the products and services we offer; forecasts of Internet usage and the size and growth of relevant markets; rapid technological changes in its industry and relevant markets; and competition in our market. Discussions containing such forward-looking statements may be found in "Management's Discussion and Analysis of Financial Condition and Results of Operations." In some cases, forward-looking statements can be identified by terminology such as "may," "will," "should," "could," "predicts," "potential," "continue," "expects," "anticipates," "future," "intends," "plans," "believes," "estimates," and similar expressions. These forward-looking statements involve certain risks and uncertainties that could cause actual results, levels of activity, performance, achievements and events to

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differ materially from those implied by such forward-looking statements. The factors that could contribute to such differences include those discussed under the caption "Risks And Uncertainties That You Should Consider Before Investing In Tumbleweed" contained herein, as well as those discussed elsewhere herein. These forward-looking statements are made as of the date of this Quarterly Report on Form 10-Q. Tumbleweed disclaims any obligation to update these statements or to explain the reasons why actual results may differ. Tumbleweed reserves the right to update these statements for any reason including the occurrence of a material event. The risks and uncertainties under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations−Risks and Uncertainties That You Should Consider Before Investing in Tumbleweed" contained herein, among other things, should be considered in evaluating Tumbleweed's prospects and future financial performance.

TUMBLEWEED COMMUNICATIONS CORP.

INDEX

		Page
	Part I	
Item 1	Financial Statements	3
	Condensed Consolidated Balance Sheets as of March 31, 2002 (unaudited) and December 31, 2001	3
	Condensed Consolidated Statements of Operations for the three months ended March 31, 2002 and December 31, 2001 (unaudited)	4
	Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2002 and 2001 (unaudited)	5
	Notes to Condensed Consolidated Financial Statements (unaudited)	6
Item 2	Management's Discussion and Analysis of Financial Condition and Results of Operations	10
Item 3	Quantitative and Qualitative Disclosures About Market Risk	27
	Part II	
Item 1	Legal Proceedings	28
Item 2	Changes in Securities and Use of Proceeds	28
Signatures		29

TRADEMARKS

Our registered trademarks include Tumbleweed®, Tumbleweed Communications®, WorldSecure® and Worldtalk®. Additional trademarks belonging to us include Tumbleweed Secure Guardian™, Tumbleweed Secure Policy Gateway™, Tumbleweed Secure Staging Server™, Tumbleweed Staging Server™, Tumbleweed Secure Mail™, Tumbleweed Secure Redirect™, Tumbleweed Secure Public Network™, Tumbleweed SPN™, Tumbleweed Secure Archive™, Tumbleweed Secure Web™, Tumbleweed Secure Inbox™, Tumbleweed Secure Envelope™, Tumbleweed Secure CRM™, Tumbleweed Secure Messenger™, Tumbleweed Secure Statements™, Tumbleweed My Copy™, Tumbleweed L2i™, Tumbleweed IME Developer™, Tumbleweed Integrated Messaging Exchange™, Tumbleweed IME™, Tumbleweed IME Personalize™, WorldSecure/Mail™ and Tumbleweed IME Alert™.

PART I−FINANCIAL INFORMATION

ITEM 1−*FINANCIAL STATEMENTS*

TUMBLEWEED COMMUNICATIONS CORP. AND SUBSIDIARIES

Condensed Consolidated Balance Sheets (in thousands)

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	March 31, 2002 (unaudited)	December 31, 2001
Assets		
Current Assets:		
Cash and cash equivalents	$ 39,782	$ 43,750
Short-term investments	762	–
Accounts receivable, net	5,468	6,795
Prepaid expenses and other current assets	1,489	2,022
Total current assets	47,501	52,567
Property and equipment, net	4,092	4,935
Goodwill, net	6,687	6,687
Other assets	1,224	1,121
Total assets	$ 59,504	$ 65,310
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 2,923	$ 2,738
Current installments of long-term debt	320	379
Accrued liabilities	6,945	8,067
Accrued restructuring	–	2,335
Deferred revenue	8,118	6,330
Total current liabilities	18,306	19,849
Long-term debt, excluding current installments	–	9
Deferred revenue	1,602	1,568
Other long-term liabilities	267	433
Total liabilities	20,195	21,859
Minority interest	208	356
Stockholders' equity:		
Common stock	31	31
Additional paid-in capital	294,234	294,727
Deferred compensation expense	(943)	(1,834)
Accumulated other comprehensive loss	(582)	(585)
Accumulated deficit	(253,619)	(249,244)
Total stockholders' equity	39,121	43,095
Total liabilities and stockholders' equity	$ 59,504	$ 65,310

See accompanying Notes to Condensed Consolidated Financial Statements

TUMBLEWEED COMMUNICATIONS CORP. AND SUBSIDIARIES

Condensed Consolidated Statements of Operations (in thousands, except per share data) (unaudited)

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	Three Months Ended March 31,	
	2002	2001
Revenue:		
Product and IP revenue	$ 5,524	$ 1,694
Service revenue	2,570	2,323
Total revenue	8,094	4,017
Cost of revenue(1)	2,183	3,052
Gross profit	5,911	965
Operating expenses:		
Research and development(2)	3,208	3,704
Sales and marketing(3)	5,616	9,291
General and administrative(4)	1,603	2,238
Stock-based compensation	262	1,334
Amortization of goodwill and intangible assets	–	7,844
Impairment of goodwill and intangible assets	–	50,983
Restructuring expenses(5)	–	8,870
Total operating expenses	10,689	84,264
Operating loss	(4,778)	(83,299)
Other income, net	407	1,031
Net loss before provision for taxes	(4,371)	(82,268)
Provision for taxes	4	26
Net loss	(4,375)	(82,294)
Other comprehensive income (loss)−translation adjustment	3	(238)
Comprehensive loss	$ (4,372)	$ (82,532)
Net loss per share−basic and diluted	$ (0.14)	$ (2.76)
Weighted average shares−basic and diluted	30,527	29,800

(1) Exclusive of non-cash stock-based compensation expense of $77 and $79 for the three months ended March 31, 2002 and 2001, respectively.

(2) Exclusive of non-cash stock-based compensation expense of $23 and $374 for the three months ended March 31, 2002 and 2001, respectively.

(3) Exclusive of non-cash stock-based compensation expense of $131 and $749 for the three months ended March 31, 2002 and 2001, respectively.

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(4) Exclusive of non-cash stock-based compensation expense of $31 and $468 for the three months ended March 31, 2002 and 2001, respectively.

(5) Exclusive of non-cash stock-based compensation expense of $0 and $(336) for the three months ended March 31, 2002 and 2001, respectively.

See accompanying Notes to Condensed Consolidated Financial Statements

TUMBLEWEED COMMUNICATIONS CORP. AND SUBSIDIARIES

Condensed Consolidated Statements of Cash Flows (in thousands) (unaudited)

	Three months ended March 31,	
	2002	**2001**
Cash flows from operating activities:		
Net loss	$ (4,375)	$ (82,294)
Adjustments to reconcile net loss to net cash used in operating activities:		
Stock-based compensation expense	262	1,334
Depreciation and amortization	859	8,961
Bad debt expense	375	808
Minority interest	(148)	(100)
Impairment of goodwill and intangible assets	–	50,983
Loss on disposal of property and equipment	48	2,614
Other non-cash items	(762)	–
Changes in operating assets and liabilities		
Accounts receivable	952	(726)
Prepaid expenses and other assets	430	28
Accounts payable and accrued liabilities	(937)	(5,951)
Accrued restructuring	(2,335)	5,639
Deferred revenue	1,822	3,062
Net cash used in operating activities	(3,809)	(15,642)
Cash flows from investing activities:		
Purchase of property and equipment	(64)	(1,462)
Net cash used in investing activities	(64)	(1,462)
Cash flows from financing activities:		
Repayments of borrowings	(234)	(295)
Proceeds from issuance of common stock	136	186
Net cash used in financing activities	(98)	(109)
Effect of exchange rate fluctuation	3	(238)
Net decrease in cash and cash equivalents	(3,968)	(17,451)
Cash and cash equivalents, beginning of period	43,750	76,097

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Cash and cash equivalents, end of period	$ 39,782	$ 58,646
Supplemental disclosures of cash flow information:		
Cash paid during the period for interest	4	28

See accompanying Notes to Condensed Consolidated Financial Statements

TUMBLEWEED COMMUNICATIONS CORP. AND SUBSIDIARIES

Notes to Condensed Consolidated Financial Statements

(1) Organization

Tumbleweed Communications Corp. ("Tumbleweed" or "we") is a leading provider of secure content management solutions for enabling business conducted on the Internet. Tumbleweed Secure Guardian is a leading enterprise-wide policy-based security framework that offers a wide range of solutions to both protect and extend enterprise networks, move business processes online and enable enterprises to communicate safely over the Internet. Tumbleweed solutions empower organizations to safely share and protect critical information, increase customer loyalty and privacy and reduce costs.

We maintain our headquarters in Redwood City, California and have incorporated subsidiaries in Japan, Switzerland, Germany, the United Kingdom, the Netherlands, Sweden, France, Australia and Hong Kong.

(2) Basis of Presentation

The consolidated condensed financial statements as of March 31, 2002 and for the three months ended March 31, 2002 and 2001 are unaudited and reflect all adjustments (consisting of normal recurring accruals except as otherwise indicated) which are, in the opinion of management, necessary for fair presentation of our financial position and operating results for the interim periods presented.

The accompanying consolidated condensed financial statements include the accounts of Tumbleweed, our wholly owned subsidiary, Worldtalk Communications Corp. ("Worldtalk"), our wholly owned subsidiary, Interface Systems Corp. ("Interface"), our wholly owned subsidiaries in Switzerland, Germany, the United Kingdom, the Netherlands, Sweden, France, Australia and Hong Kong and our majority-owned subsidiary in Japan, Tumbleweed Communications KK ("TKK").

All significant intercompany accounts and transactions have been eliminated in consolidation.

(3) Restructuring

In January 2001, our Board of Directors approved a restructuring program intended to align our cost structures with our company-wide focus on customer service, sales and research and development. The restructuring involved consolidating our facilities in the United States and closing international sales office locations in Paris, France; Chatsworth, Australia; and Stockholm, Sweden. The restructuring program also realigned our professional services organization and reduced headcount in most areas of our business.

Restructuring and related charges expensed during the quarter ended March 31, 2001 was comprised of the following (in thousands):

Employee separation	$ 2,642
Facilities charges, asset impairment, and other	6,564
Stock compensation credit, net	(336)

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Total restructuring charges	$ 8,870

Employee separation for approximately 100 employees included severance pay and medical and other benefits. The restructuring charges were partially offset by a non-cash credit related to previously recorded stock-based compensation on unvested options held by terminated employees. During the quarter ended March 31, 2002, we made lease settlement payments of $2.3 million on facilities no longer required primarily due to the reduction in headcount. As of March 31, 2002 we have no remaining liabilities from the January 2001 restructuring.

(4) Goodwill Impairment

During the three months ended March 31, 2001, we performed an impairment assessment of the identifiable intangibles and goodwill recorded in connection with the acquisition of Interface. The assessment was performed primarily due to changes in the economy, the overall decline in the industry growth rate, and our lower actual and projected operating results including that of the business acquired from Interface. Our assessment was supported by the significant sustained decline in our stock price since the valuation date of the shares issued in the Interface acquisition. As a result of the assessment, we recorded a $51.0 million impairment charge to reduce goodwill and other intangible assets to their estimated fair value. The charge was based upon the estimated discounted cash flows over the remaining useful life of the goodwill using a discount rate of 15%. The assumptions supporting the cash flows, including the discount rate, were determined using our best estimates as of March 31, 2001. The remaining intangible assets were amortized in full over their remaining useful life during 2001. The impairment consisted of the following charge (in thousands):

Goodwill	$ 49,210
Developed and core technology	1,127
Acquired workforce	646
Total impairment	$ 50,983

(5) Net Loss Per Share

Basic net loss per share is computed by dividing the net loss for the period by the weighted average number of common shares outstanding during the period. Diluted net loss per share is computed by dividing the net loss for the period by the weighted average number of common and potential common shares outstanding during the period if their effect is dilutive. Potential common shares comprise incremental common shares issuable upon the exercise of stock options and warrants. The potential common shares issuable under stock options and the potential warrants to purchase common shares have been excluded from the determination of diluted net loss per share for all periods because the effect of such shares would have been anti-dilutive.

(6) Segment Information

As defined by Statement of Financial Accounting Standards ("SFAS") 131, *Disclosure About Segments of an Enterprise and Related Information*, our chief operating decision-makers are our Chief Executive Officer ("CEO") and our Chief Operating Officer ("COO"). Our CEO and COO review financial information presented on a consolidated basis accompanied by disaggregated information about revenue by geographic region for purposes of making operating decisions and assessing financial performance. The consolidated financial information reviewed by our CEO and COO is the information presented in the accompanying consolidated statement of operations. Therefore, we operate in a single operating segment. The amount of revenue by product and service has not been provided as management has determined that it is impracticable to do so.

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Revenue information regarding operations in the different geographic regions is as follows (in thousands):

	Three months ended March 31,	
	2002	2001
North America	$ 7,323	$ 2,518
Europe	590	1,024
Asia	181	475
Total	$ 8,094	$ 4,017

Substantially all of our long-lived assets are located in the United States.

(7) Contingencies

On July 7, 2000, three complaints were filed by David H. Zimmer, Congressional Securities, Inc. and other plaintiffs against Interface Systems, Inc., a company we acquired in 2000, and various additional defendants, including Interface's prior president and chief executive officer, Robert A. Nero and Fiserv Correspondent Services, Inc., in the United States District Court for the Southern District of New York. The three cases contain substantially similar allegations of false and misleading representations by various defendants allegedly designed to inflate Interface's stock price. The complaints seek relief under the federal securities laws on behalf of purported classes of persons who purchased, held, or sold shares of Interface stock, and under various other causes of action. On September 27, 2000, we filed (i) a motion to strike or dismiss for failure to meet the certification requirements of the Private Securities Litigation Reform Act, (ii) a motion to dismiss for failure to state a claim, and (iii) a motion to dismiss because of improper venue, or in the alternative, motion to transfer the lawsuits to the Eastern District of Michigan. On July 27, 2001, the Court granted our motion to transfer the lawsuits to the Eastern District of Michigan, and left the decision on the pending motions to dismiss to the transferee Court. On April 19, 2002, the Court dismissed with prejudice plaintiffs' class allegations and federal securities law claims that purportedly arose under Section 10(b) of the Securities Exchange Act of 1934. Also on April 19, 2002, plaintiffs filed a Second Amended Consolidated Complaint that (i) consolidated the separate actions into one action; (ii) added certain new plaintiffs; (iii) withdrew Congressional Securities, Inc. ("CSI") as a plaintiff, and (iv) added claims for breach of fiduciary duty and negligent misrepresentation. The accompanying financial statements do not include any costs for damages, if any, that might result from this uncertainty. We believe these actions are without merit and intend to vigorously defend and seek their dismissal.

(8) Recent Accounting Pronouncements

In July 2001, the Financial Accounting Standards Board ("FASB") issued SFAS 142, *Goodwill and Other Intangible Assets*. SFAS 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead tested for impairment at least annually in accordance with the provisions of SFAS 142. SFAS 142 also requires that intangible assets with estimable useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment.

We adopted the provisions of SFAS 142 on January 1, 2002. In connection with SFAS 142's transitional goodwill impairment evaluation, we must perform an assessment of whether there is an indication that goodwill is impaired as of the date of adoption. To accomplish this, we have identified our reporting units and determined the carrying value of each reporting unit by assigning the assets and liabilities, including the existing goodwill and intangible assets, to those reporting units as of the date of adoption. We have up to six months from the date of adoption to determine the fair value of each

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reporting unit and compare it to the reporting unit's carrying amount. To the extent a reporting unit's carrying amount exceeds its fair value, an indication exists that the reporting unit's goodwill may be impaired and we must perform the second step of the transitional impairment test. In the second step, we must compare the implied fair value of the reporting unit's goodwill, determined by allocating the reporting unit's fair value to all of it assets (recognized and unrecognized) and liabilities to its carrying amount, both of which would be measured as of the date of adoption. This second step is required to be completed as soon as possible, but no later than the end of the year of adoption. Any transitional impairment loss will be recognized as the cumulative effect of a change in accounting principle in our consolidated statement of operations.

As of the date of adoption, we have unamortized goodwill in the amount of $6.7 million which will be subject to the transition provisions of SFAS 142. Because of the extensive effort needed to comply with adopting SFAS 142, it is not practicable to reasonably estimate the impact of adopting this Statement on our financial statements at the date of this report, including whether we will be required to recognize any transitional impairment losses as the cumulative effect of a change in accounting principle.

The following table presents net loss and loss per share information for the period ended March 31, 2001, adjusted to exclude the amortization related to goodwill that will no longer be amortized under SFAS No. 142:

Net loss, as reported	$	(82,532)
Add back: amortization of goodwill		6,238
Pro forma net loss	$	(76,294)
Loss per share, as reported	$	(2.76)
Pro forma loss per share	$	(2.56)

In June 2001, the FASB issued SFAS 143, *Accounting for Asset Retirement Obligations*, which addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. The standard applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development, or normal use of the asset. SFAS 143 requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. We are required to adopt the provisions of SFAS 143 for the quarter ending March 31, 2003. We do not expect the adoption of SFAS 143 to have a material impact on our financial position or results of operations.

On October 3, 2001, the FASB issued SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which addresses financial accounting and reporting for the impairment or disposal of long-lived assets. While SFAS 144 supersedes SFAS 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, it retains many of the fundamental provisions of SFAS 121. SFAS 144 also supersedes the accounting and reporting provisions of APB Opinion 30 for the disposal of a segment of a business. By broadening the presentation of discontinued operations to include more disposal transactions, SFAS 144 enhances companies' ability to provide information that helps financial statement users to assess the effects of a disposal transaction on the ongoing operations of an entity. We adopted SFAS 144 for the quarter ending March 31, 2002. The adoption of SFAS 144 did not have a material impact on our financial position or results of operations.

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

The following discussion should be read in conjunction with the consolidated condensed financial statements and the accompanying notes. The following discussion contains forward-looking statements that reflect our plans, estimates and beliefs. Our actual results could differ materially from those discussed in the forward-looking statements. Factors that could cause or contribute to these differences include,

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but are not limited to, those discussed below and those listed under "Risks and Uncertainties That You Should Consider Before Investing In Tumbleweed".

OVERVIEW

We are a leading provider of secure content management solutions for enabling business conducted on the Internet. Tumbleweed Secure Guardian is a leading enterprise-wide policy-based security framework that offers a wide range of solutions to both protect and extend enterprise networks, move business processes online, and enable enterprises to communicate safely over the Internet. Tumbleweed solutions empower organizations to safely share and protect critical information, increase customer loyalty and privacy and reduce costs.

Secure Guardian provides centralized security for both incoming and outgoing communications and integrates various enterprise applications for safe delivery of all forms of enterprise content. Secure Guardian is based on a platform consisting of the Tumbleweed Secure Policy Gateway and a series of protocol enablers that allow virtually any application to connect to it. The Secure Policy Gateway enables the enterprise to apply security to and manage content policies for bi-directional communications traffic, web content and Internet usage. Policies include protection from viruses, malicious mobile code or SPAM attacks, as well as protection from dangerous exposure of company, partner or customer confidential information. Tumbleweed protocol enablers allow a wide range of protocols and enterprise systems to be centrally managed from the Secure Policy Gateway to allow organizations to safely extend communications from enterprise applications, groupware and legacy systems.

Additionally, Tumbleweed Secure Guardian enables a broad spectrum of network extension solutions that help companies leverage the business efficiencies and benefits of the business Internet, including secure communications between trading partners, moving paper-based processes−such as statement presentment−online, and delivery and storage of aggregated enterprise communications into a single, branded secure inbox. Tumbleweed is trusted by 1,000 blue-chip customers including American Century Services Corp.; American Express Travel Related Services Company, Inc.; Amgen Inc.; Beckman Coulter, Inc.; Best Buy Co., Inc.; Broadcom Corp.; Diners Club International Ltd.; the U.S. Food & Drug Administration; Gap, Inc.; JP Morgan Chase & Co.; Merck & Co., Inc.; National Semiconductor Corp.; Northern Trust Corp.; Phoenix Home Life Insurance Co.; Salomon Smith Barney Inc.; Siebel Systems, Inc.; Skandaniska Enskilda Banken AB; Union Minere Oxyde (U.K.) Ltd.; Verizon Communications; Wachovia Securities, Inc.; and Wells Fargo & Co. Over 100 of the Fortune 500 use various Tumbleweed solutions today.

Revenue, which consists of both product and intellectual property (IP) revenue and services revenue, results from new contracts and backlog. We define backlog as contractual commitments that are not due and payable as of the balance sheet date and deferred revenue. Product and IP revenue consists of license fees and transaction fees. We typically offer our software products under a perpetual license. Under a perpetual license our customers pay a one-time license fee for the right to use our software. Perpetual license revenue is typically recognized upon software shipment. We enter into patent license agreements whereby licensees gain access to our patented technology for the duration of the patent in exchange for a licensing fee. We recognize revenue from IP upon execution of the patent license agreement and when billable. Transaction revenue is based on actual volume of transactions or

contractual minimum volumes, and the related revenue is recognized based on payment schedules or transaction reports from our customers. Services revenue consists of consulting fees and support and maintenance fees. Consulting fees related to installation or customization are recognized upon client acceptance or percentage of completion. Support and maintenance fees are paid for ongoing customer support and in some instances for the right to receive future upgrades of our products during the term of the maintenance agreement. Revenue from support and maintenance is recognized ratably over the period the support is provided. Revenue from the reseller channel is recognized upon software shipment and the execution of a distribution agreement and receipt of substantive identification of the end-user customer.

A portion of our revenue relates to international customers or operations. Most of our international contracts are denominated in foreign currencies. We currently do not have hedging or similar arrangements to protect us against foreign currency fluctuations. Therefore, we increasingly may be subject to currency fluctuations, which could harm our operating results in future periods.

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Our future net income and cash flow may be adversely affected by limitations on our ability to apply net operating losses for federal income tax reporting purposes against taxable income in future periods, including limitations due to ownership changes, as defined in Section 382 of the Internal Revenue Code, arising from issuance of stock.

In January 2001, our Board of Directors approved a restructuring program intended to align our cost structures with our company-wide focus on customer service, sales and research and development. The restructuring involved consolidating our facilities in the United States and closing international sales office locations in Paris, France; Chatsworth, Australia; and Stockholm, Sweden. The restructuring program also realigned our professional services organization and reduced headcount in most areas of our business. The reduction in force involved approximately 100 employees and total charges incurred as a result of the restructuring were $8.9 million during the three months ended March 31, 2001, which includes charges related to vacating leased facilities domestically and abroad. As of March 31, 2002 we have no remaining liabilities from the January 2001 restructuring.

RESULTS OF OPERATIONS

Three Month Periods Ended March 31, 2002 and 2001

Revenue. Revenue is comprised of product and IP revenue and services revenue. Total revenue for the three months ended March 31, 2002 increased to $8.1 million from $4.0 million for the same three months in 2001. The increase in total revenue was due to a number of new contracts being recognized on a subscription basis in 2001 as well as increases in maintenance fees from our installed customer base.

Product and IP revenue for the three months ended March 31, 2002 increased to $5.5 million from $1.7 million for the same three months in 2001. The increase in product and IP revenue was due to a number of new contracts being recognized on a subscription basis in the three months ended March 31, 2001. Additionally, we recognized no IP revenue in the quarter ended March 31, 2001.

Services revenue for the three months ended March 31, 2002 increased to $2.6 million from $2.3 million for the same three months in 2001. The increase in services revenue was due to increases in maintenance fees from our installed customer base.

Cost of Revenue. Cost of revenue is comprised of product and IP costs and services costs. Product license cost is primarily comprised of royalties paid to third parties for software licensed by us for inclusion in our products and bandwidth costs associated with hosting servers for those customers who use our hosting services. Services costs are comprised primarily of personnel and overhead costs related to customer support and contract development projects. Total cost of revenue for the three months ended March 31, 2002 decreased to $2.2 million from $3.1 million for the same three months in

2001. The decrease in total cost of revenue was primarily due to a decrease in service costs caused by a decrease in personnel expenses and decreased product and IP costs resulting from lower royalty expenses.

Research and Development Expenses. Research and development expenses are comprised of engineering and related costs associated with the development of our applications, quality assurance and testing. Research and development expenses for the three months ended March 31, 2002 decreased to $3.2 million from $3.7 million for the same three months in 2001. The decrease in research and development expenses was primarily due to a decrease in personnel costs.

Sales and Marketing Expenses. Sales and marketing expenses are comprised of salaries, commissions, travel expenses and costs associated with trade shows, advertising and other marketing efforts. Sales and marketing expenses for the three months ended March 31, 2002 decreased to $5.6 million from $9.3 million for the same three months in 2001. The decrease in sales and marketing expenses was primarily due to decreased personnel costs and lower marketing program expenses.

General and Administrative Expenses. General and administrative expenses consist primarily of personnel and support costs for our finance, legal, information systems, and human resources departments as well as professional fees. General and administrative expenses for

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the three months ended March 31, 2002 decreased to $1.6 million from $2.2 million for the same three months in 2001. The decrease in general and administrative expenses was primarily due to decreased personnel costs and lower bad debt expense.

Stock Compensation Expense. Stock compensation expense was recorded in connection with the amortization of deferred stock compensation recorded as a result of grants of stock options to non-employees and employees at exercise prices less than the deemed fair value on the grant date, the vesting acceleration of stock options approved for certain employees, and warrants granted to non-employees in exchange for services performed, net of a credit related to stock options granted to employees who were later terminated. The credit resulted from the reversal of stock compensation expense previously recorded for options cancelled that had not vested. Stock compensation expense for the three months ended March 31, 2002 decreased to $262,000 from $1.3 million for the same three months in 2001. The decrease was the result of the termination of certain employees whose options had not yet vested.

Amortization of Goodwill and Intangible Assets. Goodwill and other intangible assets resulted from the Interface purchase and, to a lesser extent, our increase in ownership of Tumbleweed KK from 50% to 80% during 2000. In July 2001, the FASB issued SFAS 142, *Goodwill and Other Intangible Assets*. SFAS 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead tested for impairment at least annually in accordance with the provisions of SFAS 142. SFAS 142 also requires that intangible assets with estimable useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. We adopted the provisions of SFAS 142 effective January 1, 2002. Prior to our adoption of SFAS 142, goodwill and intangible assets were amortized over their respective lives, generally one to five years. Amortization of goodwill and intangible assets for the three months ended March 31, 2002 decreased to $0 from $1.3 million for the same three months in 2001 as a result of the adoption of SFAS 142.

Impairment and Restructuring Expenses. In January 2001, our Board of Directors approved a restructuring program intended to align our cost structures with our company-wide focus on customer service, sales and research and development. The restructuring involved consolidating our facilities in the United States and closing international sales office locations in Paris, France; Chatsworth, Australia; and Stockholm, Sweden. The restructuring program also realigned our professional services organization and reduced headcount in most areas of our business. The reduction in force involved

approximately 100 employees and total charges incurred as a result of the restructuring were $8.9 million during the three months ended March 31, 2001, which includes charges related to vacating leased facilities domestically and abroad. As of March 31, 2002 we have no remaining liabilities from the January 2001 restructuring.

During the three months ended March 31, 2001, we performed an impairment assessment of the identifiable intangibles and goodwill recorded in connection with the acquisition of Interface. The assessment was performed primarily due to changes in the economy, the overall decline in the industry growth rate, and our lower actual and projected operating results including that of the business acquired from Interface. Our assessment was supported by the significant sustained decline in our stock price since the valuation date of the shares issued in the Interface acquisition. As a result of the assessment, we recorded a $51.0 million impairment charge to reduce goodwill and other intangible assets to their estimated fair value. The charge was based upon the estimated discounted cash flows over the remaining useful life of the goodwill using a discount rate of 15%. The assumptions supporting the cash flows, including the discount rate, were determined using our best estimates as of March 31, 2001. The remaining intangible assets were amortized in full over their remaining useful life during 2001.

Other Income, Net. Other income, net, is primarily comprised of interest income earned on investment securities. Other income, net, for the three months ended March 31, 2002 decreased to $407,000 from $1.0 million for the same three months in 2001. The decrease in other income, net, is due to the decline in interest rates and a reduction in our cash balances relative to the year-earlier period.

LIQUIDITY AND CAPITAL RESOURCES

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Since inception, we have financed our operations primarily through the issuance of equity securities. On March 31, 2002, we had approximately $40.5 million in cash, cash equivalents, and short-term investments, including restricted cash deposits related to our facilities in Redwood City, California and New York, New York.

Net cash used in operating activities for the three months ended March 31, 2002 was approximately $3.8 million. Cash used in operating activities was primarily the result of lease settlement payments of $2.3 million on facilities no longer required and net operating losses, offset by an increase in deferred revenue, a decrease in accounts receivable, and non-cash charges for depreciation and amortization.

Net cash used in investing activities for the three months ended March 31, 2002 was approximately $64,000. Net cash used in investing activities was comprised of purchases of property and equipment.

Net cash used in financing activities for the three months ended March 31, 2002 was approximately $98,000. Cash used in financing activities was primarily the result of repayments of borrowings offset by proceeds from the issuance of equity securities under our stock option and employee stock purchase plans.

As of March 31, 2002, our principal commitments consisted of obligations related to outstanding operating and capital leases. Our equipment leases require payment of rental fees to third party leasing providers. In most cases, we have no obligations to purchase the equipment at the end of the lease term. We do not anticipate a substantial increase in capital expenditures in the immediate future. We also do not anticipate an increase in operating lease obligations.

Our capital requirements depend on numerous factors, including revenue generated from operations and market acceptance of our products and services, the resources devoted to the development of our products and services and the resources devoted to sales and marketing. We have experienced a substantial increase in capital expenditures and operating expenses since inception

consistent with relocation and the growth in operations and staffing; however, we have decreased our spending on capital expenditures in recent quarters and do not anticipate increases in capital expenditures in the foreseeable future. We expect to experience a seasonal reduction in sales in Europe during the summer months. In addition, many of our customers delay purchases of our products until the end of each quarter. We believe that our existing capital resources will enable us to maintain our current and planned operations for at least the next 12 months; however, we may need to raise funds prior to that time.

We will continue to consider future financing alternatives, which may include the incurrence of indebtedness, additional public or private equity offerings or an equity investment by a strategic partner; however, we have no present commitments or arrangements assuring us of any future equity or debt financing. Additionally, equity or debt financing may not be available to us on favorable terms, if at all.

Contractual Obligations and Commercial Commitments

Future cash payments for contractual obligations and commercial commitments as of March 31, 2002, are as follows (in thousands):

	2002	2003	2004	2005	2006	After 2006	Total
Debt	$ 249	$ –	$ –	$ –	$ –	$ –	$ 249
Capital leases	57	22	–	–	–	–	79
Operating leases	2,032	2,293	1,758	128	–	–	6,211
Unconditional purchase obligations	737	826	36	–	–	–	1,598
Total	$ 2,826	$ 3,141	$ 1,794	$ 128	$ –	$ –	$ 7,888

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CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments in determining the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. We regularly evaluate our estimates, including those related to customer arrangements, bad debts, valuation of assets, and contingencies and litigation. When making estimates, we consider our historical experience, our knowledge of economic and market factors and various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

We believe that the following critical accounting policies represent areas where significant judgments and estimates have been used in the preparation of our consolidated financial statements.

Revenue Recognition

We derive our revenue from two sources (i) product and IP revenue, which includes license and transaction fees, and patent license agreement fees, and (ii) services revenue, which includes consulting, support, and maintenance fees. As described below, significant management judgments and estimates must be made and used in connection with the revenue recognized in any accounting period. Material differences may result in the amount and timing of our revenue for any period if our management made different judgments or utilized different estimates.

We typically offer our software products under a perpetual license. Our hosting arrangements require customers to pay a one-time license fee for the right to use our software. We enter into patent license agreements whereby licensees gain access to our patented technology for the duration of the patent in exchange for a licensing fee. Transaction fees are based on the volume of transactions or contractual minimum volumes. Support and maintenance fees are paid, in general, for ongoing customer support during the term of the maintenance agreement.

We apply the provisions of Statement of Position (SOP) 97-2, "Software Revenue Recognition", and SOP 98-9, "Software Revenue Recognition with Respect to Certain Arrangements", which generally requires revenue recognized from software arrangements to be allocated to each element of the arrangement based on the relative fair values of the elements, such as software products, consulting, training, installation, or post-contract customer support. Fair values are based upon vendor specific objective evidence. If such evidence does not exist for delivered elements, we record revenue using the residual method. If such evidence does not exist for undelivered elements, all revenue from the arrangement is deferred until such time that evidence of fair value does exist, or until all elements of the arrangement are delivered, or revenue is recorded ratably if the only undelivered element is post-contract customer support. For undelivered elements such as consulting services where we can not ascertain the extent of services a customer may implement, the fair value of the consulting services is estimated to be the maximum amount to which the customer is entitled.

We recognize revenue from perpetual licenses upon shipment when the following provisions are met: (i) persuasive evidence of an arrangement exists, generally based on an executed contract and non-binding purchase order; (ii) the product has been delivered, generally to a common carrier; (iii) the fee is fixed and determinable, and (iv) collection of the resulting receivable is reasonably assured. We recognize revenue from IP upon execution of the patent license agreement and when billable. Transaction revenue is recognized based on payment schedules or transaction reports from our customers. A number of our contracts include minimum transaction volume requirements. In these cases, the minimum guaranteed revenue is recognized when fees are due and payable during those months where transaction volume does not exceed the designated minimums.

Consulting fees related to installation or customization are recognized upon client acceptance or percentage of completion. Revenue from support and maintenance is recognized ratably over the period the support is provided.

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We assess collection based on a number of factors, including past transaction history with the customer and the credit-worthiness of the customer. We do not request collateral from our customers. If we determine that collection of a fee is not probable, we defer the fee and recognize revenue at the time collection becomes probable, which is generally upon receipt of cash.

Valuation of Allowance for Doubtful Accounts

The preparation of financial statements requires us to make estimates and assumptions that affect the reported amount of assets, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reported period. We must make estimates of the collectability of our accounts receivables. We specifically analyze accounts receivable including review of historical bad debts, customer concentrations, customer credit-worthiness, current economic trends, aging of the balance, geographic and industry mix, and changes in our customer payment terms when evaluating the adequacy of the allowance for doubtful accounts.

Valuation of Privately-Held Investments

Our determination of impairment related to certain equity investments in privately held companies are based on the latest available valuation of such investment, or, if unavailable, our assumptions related to projected operating results of the privately held company and potential effects of declines in market trends. Future events that adversely change the assumptions we use to determine valuation of investments may require us to record charges for impairment of the carrying value of our investments.

Valuation of long-lived assets and goodwill

We assess the impairment of identifiable intangibles, long-lived assets and goodwill whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors we consider important which could trigger an impairment review include the following:

- Significant underperformance relative to expected historical or projected future operating results;
- Significant changes in the manner or our use of the acquired assets or the strategy for our overall business;
- Significant negative industry or economic trends;
- Significant decline in our stock price for a sustained period; and
- Our market capitalization relative to net book value.

When we determine that the carrying value of long-lived assets and goodwill may not be recoverable upon the existence of one or more of the above indicators of impairment, and such carrying value is less than projected undiscounted cash flows attributed to the asset, we measure any impairment based on the amount by which the carrying amount of the assets exceeds the fair value of the assets.

Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets" became effective on January 1, 2002 and as a result, we have ceased to amortize approximately $6.7 million of goodwill. In lieu of amortization, we are required to perform

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an initial impairment review of our goodwill in 2002 and an annual impairment review thereafter. We expect to complete our initial review during the first half of 2002.

RISKS AND UNCERTAINTIES THAT YOU SHOULD CONSIDER BEFORE INVESTING IN TUMBLEWEED.

Because we are in an early stage of development and have a history of losses, it is difficult to evaluate our business and we may face expenses, delays and difficulties.

We have only a limited operating history upon which an evaluation can be based. Accordingly, our prospects must be considered in light of the risks, expenses, delays and difficulties frequently encountered by companies in a similarly early stage of development, particularly companies engaged in new and rapidly evolving markets like ours. We incurred net losses of $114.2 million, $69.8 million, and $24.2 million in the years ended December 31, 2001, 2000, and 1999, respectively. As of March 31, 2002, we had incurred cumulative net losses of $253.6 million.

We anticipate continued losses.

Our success may depend in large part upon our ability to generate sufficient revenue to achieve profitability and to effectively maintain existing relationships and develop new relationships with customers and strategic partners. If we do not succeed, our revenue may not increase, and we may not achieve or maintain profitability on a timely basis or at all. In particular, we intend to expend significant financial and management resources on product development, sales and marketing, strategic relationships, technology and operating infrastructure. As a result, we expect to incur additional losses and continued negative cash flow from operations for the foreseeable future.

Our quarterly financial results are subject to significant fluctuations.

As a result of our limited operating history and the emerging nature of the markets in which we compete, we may not be able to accurately forecast our revenue or expenses. Our success is dependent

upon our ability to enter into and maintain profitable relationships with customers and to develop and maintain profitable usage of our products by our customers and their end-users.

Our revenue has fluctuated and our quarterly operating results will continue to fluctuate based on the timing of the execution and termination of customer agreements in a given quarter. Under the traditional software licensing model, license revenue is comprised of initial license and distribution fees. As a result, we typically recognize initial license fees as revenue in the same quarter an agreement was signed. To the extent that customers purchase our product under the subscription-based pricing model, however, we account for and report our contracted revenue over the life of the agreement.

Our services revenue historically has been comprised largely of implementation, customization and consulting fees as well as customer support contracts. Our ability to receive revenue from services is subject to multiple risks, including the risk that we may not be able to meet increasing customer demand because of a lack of adequately trained personnel, and the risk that customers may not timely accept the services provided and delay payment for such services.

In addition, we have experienced, and expect to continue to experience, fluctuations in revenue and operating results from quarter to quarter for other reasons, including, but not limited to:

- the amount and timing of operating costs and capital expenditures relating to our business, operations and infrastructure, including our international operations;

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- our ability to accurately estimate and control costs;

- our ability to timely collect fees owed by customers;

- the announcement or introduction of new or enhanced products and services in the secure content management, content security, secure online communications, or document delivery markets; and

- acquisitions that we complete or propose.

As a result of these factors we believe that quarter-to-quarter comparisons of our revenue and operating results are not necessarily meaningful, and that these comparisons may not be accurate indicators of future performance. Quarterly financials that include revenue accounted for under the both the subscription-based pricing model and the traditional software pricing model will not be comparable with historical quarters that used our previous licensing model. Because our staffing and operating expenses are based on anticipated revenue levels, and because a high percentage of our costs are fixed, small variations in the timing of the recognition of specific revenue could cause significant variations in operating results from quarter to quarter. In addition, many of our customers delay purchases of our products until the end of each quarter. If we are unable to adjust spending in a timely manner to compensate for any unexpected revenue shortfall, any significant revenue shortfall would likely have an immediate negative effect on our operating results. Moreover, we believe the difficulties outlined above with respect to financial forecasts also apply to securities analysts that may publish estimates of our financial results. Our operating results in one or more future quarters may fail to meet the expectations of securities analysts or investors due to any of a wide variety of factors, including fluctuations in financial ratios or other metrics used to measure our performance. If this occurs, we would expect to experience an immediate and significant decline in the trading price of our stock.

In addition, the terrorist acts of September 11, 2001 in New York City, Washington D.C. and Pennsylvania, as well as the response, military and otherwise, by the United States, have created an uncertain economic environment and we cannot predict the impact of these events, any subsequent terrorist acts or of any related military action, on our customers or business. We believe that, in light of these events, some businesses may curtail spending on information technology, which could also affect our quarterly results or financial condition in the future.

Restructuring of operations and other cost reducing measures we have implemented may not achieve the results we intend and even may harm our business.

In January 2001, we announced a restructuring of our business, which included a reduction in force and the closure of three international locations. Since that time we have engaged in other ongoing measures to reduce expenses and establish an enterprise that is appropriate for our expected revenue levels. The planning and implementation of this effort has placed, and may continue to place, a significant strain on our managerial, operational, financial and other resources. Additionally, the actions undertaken to restructure the business may negatively affect our employee turnover, recruiting and retention of important employees. If we are unable to implement our restructuring effectively or if we experience difficulties in carrying out the restructuring, our expenses could increase more quickly than we expect. If we find that the actions taken to date did not sufficiently decrease the growth of our expenses, we may find it necessary to implement further streamlining of our expenses, to perform additional reductions in our headcount or to undertake additional restructurings of our business.

We may have insufficient cash reserves to see us through to profitability.

As of March 31, 2002, we had cash and short-term investments of $40.5 million and incurred cumulative net losses of $253.6 million. Our current cash reserves may be insufficient in the face of either lower than expected revenues or extraordinary or unexpected cash expenses.

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As a result, we may be required to raise funds through public or private financings, strategic relationships, or other arrangements. Funding, if needed, however, may not be available on acceptable terms or at all. If adequate funds are not available, we may be required to curtail significantly or defer one or more of our operating goals or programs, or take other steps that could harm our business.

A limited number of customers account for a high percentage of our revenue and the failure to maintain or expand these relationships could harm our business.

The loss of one or more of our major customers, the failure to attract new customers on a timely basis or a reduction in usage and revenue associated with the existing or proposed customers would harm our business and prospects. For the three months ended March 31, 2002 one customer comprised approximately 18% of our revenue. For the three months ended March 31, 2001, no single customer comprised 10% or more of our revenue. For the three months ended March 31, 2002 and 2001, five customers comprised approximately 42% and 21% of our revenue, respectively.

If we do not secure key relationships with enterprise customers, our access to broader markets will be limited.

Our enterprise customers, which use or intend to use our products to intelligently manage the incoming and outgoing online communications of their enterprises, are a significant source of our revenue. A key aspect of our strategy is to access target markets prior to adoption of alternative solutions by the larger participants in these markets. The failure to secure key relationships with new enterprise customers in targeted markets could limit or effectively preclude our entry into these target markets, which would harm our business and prospects.

Customers in a preliminary phase of implementing our product may not proceed on a timely basis or at all.

Some of our customers are currently in a pre-production or pre-launch stage of implementing our products and may encounter delays or other problems in introducing them. A customer's decision not to do so or a delay in implementation could result in a delay or loss in related revenue or otherwise harm our businesses and prospects. We cannot predict when any customer that is currently in a pilot or preliminary phase will implement broader use of our services.

Our service provider customers may compete with us, fail to promote our product or cease to use our products at all.

To date, we have generated a significant amount of Tumbleweed Secure Messenger revenue from contracts with a limited number of service provider customers, which use or intend to use our products for the communication of third-party documents and data. If these customers do not effectively promote the use of Secure Messenger to their end-users or cease to offer Secure Messenger to their end-users, the adoption of our services and the recognition of associated revenue could be limited. Because our contracts with our service provider customers are non-exclusive, these customers could elect to offer competing secure online communication services to their customers through our existing or future competitors. The service provider customers also may compete with our secure online communication services through their traditional physical delivery channels.

The markets for enhanced online content management services generally, and for our products specifically, are new and may not develop.

The market for our products and services is new and evolving rapidly. If the market for our products and services fails to develop and grow, or if our products and services do not gain broad market acceptance, our business and prospects will be harmed. In particular, our success will depend upon the adoption and use by current and potential customers and their end-users of secure content management services. Our success will also depend upon acceptance of our technology as the standard for providing these services. The adoption and use of our products and services will involve changes in the manner in which businesses have traditionally exchanged information. In some cases, our customers have little experience with products, services and technology like those offered by us. Our ability to influence usage of our products and services by customers and end-users is limited. For example, the usage of Secure Messenger by the end-users of our service provider

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customers has been limited to date. We have spent, and intend to continue to spend, considerable resources educating potential customers and their end-users about the value of our products and services. It is difficult to assess, or to predict with any assurance, the present and future size of the potential market for our products and services, or our growth rate, if any. Moreover, we cannot predict whether our products and services will achieve any market acceptance. Our ability to achieve our goals also depends upon rapid market acceptance of future enhancements of our products and our ability to identify new markets as they emerge. Any enhancement that is not favorably received by customers and end-users may not be profitable and, furthermore, could damage our reputation or brand name. Any failure to identify and address new market opportunities could harm our business and prospects.

We may not find broad acceptance of the Tumbleweed Secure Guardian suite of products.

In October of 2001 we re-launched our existing product line under the Tumbleweed Secure Guardian suite of products including Tumbleweed Secure Mail (formerly Tumbleweed MMS) and Tumbleweed Secure Messenger, Tumbleweed Secure Statements (formerly IME and IME Statements) and Tumbleweed Secure Redirect (formerly MMS Secure Redirect). If we do not obtain anticipated acceptance and understanding of these re-branded product offerings, our ability to grow our sales may suffer. In addition, if we do not achieve the anticipated growth of the new marketing or even suffer sales decreases as a result of misperceptions of our products, we may be forced to expend additional resources in new or different marketing directions.

The markets we address are highly competitive and rapidly changing, and we may not be able to compete successfully.

We may not be able to compete successfully against current and future competitors, and the multiple competitive pressures we face could harm our business and prospects. The markets in which we compete are intensely competitive and rapidly changing.

Our principal competition for our Tumbleweed Secure Guardian protection solutions are companies that offer various Internet content security, web security, messaging policy management, and enterprise relationship management products. Companies that sell products that compete with some of the features within our products include Kana Communications, Inc.; Clearswift Technologies; Symantec Corp.; and Trend Micro Incorporated.

Our principal competition in the secure document delivery and statement presentment market area comes from other online communication or information security service providers, some of which have services or products that are intended to compete directly with our products or that could be used as alternatives to our products. Examples of some of these providers are Automatic Data Processing, Inc.; DST Systems, Inc.; New River Systems; and PostX Corporation. Our solutions can be an alternative to traditional mail and courier delivery services such as those offered by Federal Express Corporation, UPS, or the U.S. Postal Service, and to general purpose e-mail applications and services. In addition, companies with which we do not presently directly compete may become competitors in the future, either through the expansion of our products or through their product development in the area of secure online communication services. These companies include International Business Machines Corporation/Lotus Development Corporation, and Microsoft Corporation.

The principal competitive factors in our industry include price, product functionality, product integration, platform coverage and ability to scale, worldwide sales infrastructure and global technical support. Some of our competitors have greater financial, technical, sales, marketing and other resources than we do, as well as greater name recognition and a larger installed customer base. Additionally, some of these competitors have research and development capabilities that may allow them to develop new or improved products that may compete with product lines we market and distribute. We expect that the market for secure content management software will become more consolidated with larger companies being better positioned to compete in such an environment in the long term. As this market continues to develop, a number of companies with greater resources than ours could attempt to increase their presence in this market by acquiring or forming strategic alliances with our competitors or business partners. Our success will depend on our ability to adapt to these competing forces, to develop more advanced products more rapidly and less expensively than our competitors, and to educate potential customers as to the benefits of licensing our products rather than developing their own products. Competitors could introduce products with superior features, scalability and functionality at lower prices than our products and could also bundle existing or new products with other more established

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products in order to compete with us. In addition, because there are relatively low barriers to entry for the software market, we expect additional competition from other established and emerging companies. Increased competition is likely to result in price reductions, reduced gross margins and loss of market share, any of which could harm our business.

Our recent product releases may not be accepted and our development efforts may be hindered by a variety of factors.

In October 2001 we released the newest versions of our existing product lines (Secure Mail 5.0 and Secure Messenger 5.0) under the Secure Guardian Framework. These releases may not be scalable, may contain unexpected bugs or problems, may not meet customers' requirements or expectations and may not be accepted as providing added value to our existing customers. In addition, the installation of integrated or complementary software products at customer sites may result in difficulties associated with customer-specific installation processes and may result in new issues arising with respect to our new software releases.

The restructuring of our business has placed a strain on resources.

We restructured our business in 2001, which has placed, and continues to place, a significant strain on managerial, informational, administrative and operational resources. Our current systems, procedures and controls may not be adequate to achieve the rapid execution necessary to effectively operate within the market for our products and services. We need to continue to enhance and improve our managerial capacity, and improve or replace our existing operational, customer service and financial systems, procedures and controls. Any failure to properly manage these systems and procedural transitions could impair our ability to attract and service customers, and could cause us to incur higher operating costs and delays in the execution of our business plan. Despite our restructuring, we expect that we may need to continue the expansion of our employee base. Our management may not be able to hire, train, retain, motivate and manage required personnel. In addition, our management may not be able to successfully identify, manage and exploit existing and potential market opportunities. If we cannot manage growth effectively, our business and operating results could suffer. Finally, we may have operational, customer service and financial systems that are not appropriate for our current estimated size. Moving to more appropriate office systems may also place a strain on our current systems and require financial expenditures to end the commitments on other systems.

We have a lengthy sales and implementation cycle which could harm our business.

If we are unable to license our services to new customers on a timely basis or if our existing and proposed customers and their end-users suffer delays in the implementation and adoption of our services, our revenue may be limited and business and prospects may be harmed. Our customers must evaluate our technology and integrate our products and services into the products and services they provide. In addition, our customers may need to adopt a comprehensive sales, marketing and training program in order to effectively implement some of our products. Finally, we must coordinate with our customers using our product for third-party communications in order to assist end-users in the adoption of our products. For these and other reasons, the cycle associated with establishing licenses and implementing our products can be lengthy. This cycle is also subject to a number of significant delays over which we have little or no control. Forecasts about license revenue may be inaccurate as a result of any or all of these factors, and inaccurate forecasts may cause our business, or market valuation, to suffer.

A failure to protect our intellectual property may significantly harm our business.

We currently rely on a combination of patents, trade secrets, copyrights, trademarks and licenses, together with non-disclosure and confidentiality agreements to establish and protect our proprietary rights in our products. We hold certain patent rights with respect to some of our products. We have filed, and expect in the future to file, additional patent applications. Our existing patents or trademarks, as well as any future patents or trademarks obtained by us, may be challenged, invalidated or circumvented, or our competitors may independently develop or patent technologies that are substantially equivalent or superior to our technology. Further patent or trademark protection may not be obtained, in the United States or elsewhere, for our existing or new products, applications or services. In addition, further protection, if obtained, may not be effective. In some countries, meaningful patent or trademark protection is not available.

To date, we have not received any material claims of infringement upon the proprietary rights of third parties. However, third parties could assert infringement claims against us in the future, and the cost of responding to such assertions, regardless of their validity, could be

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significant. We may increasingly be subject to claims of intellectual property infringement as the number of our competitors grows and the functionality of their products and services increasingly overlap with ours. We aggressively seek to enforce our patent and other intellectual property rights, which may further increase the risk of adverse claims. Any of these claims, with or without merit, could be time

consuming to defend, result in costly litigation, divert management's attention and resources, limit use of our services or require us to enter into royalty or license agreements. In addition, such claims may be found to be valid and could result in awards against us, which could harm our business.

We also rely, to some extent, on unpatented trade secrets and other unpatented proprietary information. Our policy is to have employees sign confidentiality agreements, to have selected parties sign non-competition agreements and to have third parties sign non-disclosure agreements. Although we take precautionary measures to maintain our unpatented proprietary information, others may acquire equivalent information or otherwise gain access to or disclose our proprietary information and we may be unable to meaningfully protect our rights to our proprietary information.

Profitable expansion in international markets may be difficult.

We invested significant financial and managerial resources to expand our sales and marketing operations in international markets and have opened sales offices in Germany, Hong Kong, Japan, the Netherlands, Switzerland, and the United Kingdom. For the three months ended March 31, 2002 and 2001, we derived 10%, and 37%, respectively, of our revenue from international operations. However, to date, we have limited experience in international operations and may not be able to compete effectively in international markets. A key component of our long-term strategy is to further expand into international markets, and we must continue to devote substantial resources to our international operations in order to succeed in these markets. In this regard, we may encounter difficulties such as:

- unexpected changes in regulatory requirements and trade barriers applicable to the Internet or our business,
- challenges in staffing and managing foreign operations, including employment laws and practices as we expand into continental Europe,
- seasonal reductions in business activity and economic downturns, in particular, in Europe and Asia,
- longer payment cycles and problems in collecting accounts receivable,
- problems associated with the conversion of various European currencies into a single currency, the Euro,
- legal challenges or regulatory requirements related to the export or import of encryption technologies,
- differing technology standards, and
- reduced protection for intellectual property rights in certain countries in which we operate or plan to operate.

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In addition, our expansion into international markets will increasingly subject us to fluctuations in currency exchange rates. In the future, an increasing number of our contracts may be denominated in currencies other than U.S. dollars. We do not presently engage in hedging or similar transactions to protect us from currency fluctuations. Any of the foregoing difficulties of conducting business internationally could harm our international operations and, consequently, our business and prospects.

If we do not provide adequate support services to our customers to implement our products, our business may suffer.

Our professional services organization assists our customers in implementing our products through software installation, integration with existing customer systems, contract engineering, consulting and training. If the professional services organization does not adequately assess customer requirements or address technical problems, customers may seek to discontinue their relationships with us due to

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dissatisfaction with the product or our customer support. Furthermore, these customers may realize lower usage than they could have otherwise achieved because they did not fully capitalize on the product in ways that could have been addressed by our professional services organization. Our products must be integrated with existing hardware and complex software products of our customers or other third parties, and our customers may not have significant experience with the implementation of products similar to our own. In addition, profitably providing contract engineering and integration services is an increasingly important aspect of our strategy to strengthen customer loyalty to our product and company. Therefore, our business and future prospects significantly depend on the strength of our professional services organization and our ability to leverage this organization by augmenting our reach through trained and qualified systems integrators. If our professional services organization does not adequately meet these multiple challenges, our business and prospects could suffer.

Product performance problems, system failures, and internet problems could severely damage our business.

The ability of our customers to use Tumbleweed-based services depends on stable product performance, and the efficient and uninterrupted operation of the computer and communications hardware as well as the software and Internet network systems that they maintain. Although our ability to manage the effects of system failures which occur in computer hardware, software and network systems is limited, the occurrences of these failures could harm our reputation, business and prospects. The Internet has experienced a variety of outages and other delays as a result of damage to portions of our infrastructure, and the Internet could face similar outages and delays in the future. In addition, an increasing number of our customers require us to provide computer and communications hardware, software and Internet networking systems to them as an outsourced data center service. All data centers, whether hosted by us, our customers or by an independent third party to which it outsources this function, are vulnerable to damage or interruption from fire, flood, earthquake, power loss, telecommunications failure or other similar events.

If our software contains errors, we may lose customers or experience reduced market acceptance of our products.

Our software products are inherently complex and may contain defects and errors that are detected only when the products are in use. In addition, some of our customers require or may require enhanced customization of our software for their specific needs, and these modifications may increase the likelihood of undetected defects or errors. Further, we often render implementation, consulting and other technical services, the performance of which typically involves working with sophisticated software, computing and networking systems, and we could fail to meet customer expectations as a result of any defects or errors. As a result, we may lose customers, customers may fail to implement our products more broadly within their organization and we may experience reduced market acceptance of our products. Some of our products are designed to facilitate the secure transmission of sensitive business information to specified parties outside the business over the Internet. As a result, the reputation of our software products for providing good security is vital to their acceptance by customers. Our products may be vulnerable to break-ins, theft or other improper activity that could jeopardize the security of information for which we are responsible. Problems caused by product defects, failure to meet project milestones for services or security breaches could result in loss of or delay in revenue, loss of market share, failure to achieve market acceptance, diversion of research and development resources, harm to our reputation, or increased insurance, service and warranty costs. To address these problems, we may need to expend significant capital resources that may not have been budgeted.

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We may be unable to recruit, retain and motivate qualified personnel, which could harm our business, including product development.

We must continue to identify, recruit, hire, train, retain and motivate highly skilled technical, managerial, sales, marketing and customer service personnel. Competition for these personnel is intense, and we may not be able to successfully recruit, assimilate or retain sufficiently qualified personnel. In particular, we may encounter difficulties in recruiting a sufficient number of qualified software developers and sales personnel, and we may not be able to retain these employees. The failure to recruit and retain necessary technical, managerial, sales, merchandising, marketing and customer service personnel could harm our business and our ability to obtain new customers and develop new products. Although we have used and continue to use stock options as a retention tool, many of our employees hold stock options that are "underwater" (i.e., the market price of our stock is below their option exercise price) and these options may be ineffective as a retention tool. Our employee turnover may increase if outstanding stock options continue to remain underwater and we do not adjust the option exercise prices. Any adjustment of stock option exercise prices may result in dilution to our stockholders and depress our stock price.

If we lose the services of executive officers or other key employees, our ability to develop our business and secure customer relationships will suffer.

We are substantially dependent on the continued services and performance of our executive officers and other key personnel. The loss of the services of any of our executive officers or other key employees could significantly delay or prevent the achievement of our development and strategic objectives. We do not have long-term employment agreements with any of our key personnel. The loss of services of any of our executive officers or other key personnel could significantly harm our business and prospects.

Our efforts to establish, maintain and strengthen our brands will require significant expenditures and may not be successful.

If the marketplace does not associate our brands with high quality Internet communication services, it may be more difficult for us to attract new customers or introduce future products and services. The market for our services is new. Therefore, our failure to establish brand recognition at this stage could harm our ability to compete in the future with other companies that successfully establish a brand name for their services. We must succeed in our marketing efforts, provide high quality services and increase our user base in order to build our brand awareness and differentiate our products from those of our competitors. These efforts have required significant expenditures to date. Moreover, we believe that these efforts will require substantial commitments of resources in the future as our brands become increasingly important to our overall strategy and as the market for our services grows.

Because our products utilize the Internet, if use of the Internet does not increase, or the architecture of the Internet is altered, the level of use of our products will suffer.

If the Internet and other products and services necessary for the utilization of our products are not sufficiently developed, fewer customers and end-users will use our products and our business will be harmed. In particular, the success of our products and services will depend on the development and maintenance of adequate Internet infrastructure, such as a reliable network backbone with the necessary speed, data capacity and other features demanded by users. Moreover, our success will also depend on the timely development of complementary products or services such as high-speed Internet connections for providing reliable access and services and this may not occur. Moreover, changes in the architecture of the Internet may limit the success of our products. Because the online exchange of information is new and evolving, the Internet may not prove to be a viable platform for secure online

communication services in the long term. The Internet has experienced, and is expected to continue to experience, significant growth in the numbers of users and amount of traffic. As the Internet continues to experience increased numbers of users and frequency of use, or if its users

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require increasingly more resources, the Internet infrastructure may not be able to support the demands placed on it. As a result, the performance or reliability of the Internet may be harmed. This in turn could decrease the level of Internet usage and also the level of utilization of our products and services.

Government regulation relating to the Internet may increase costs of doing business or require changes in our business model.

We are subject to regulations applicable to businesses generally and laws or regulations directly applicable to companies utilizing the Internet. Although at present there are relatively few specific laws and regulations directly applicable to the Internet, it is possible that a number of laws and regulations may be adopted with respect to the Internet. These laws could cover issues like user privacy, pricing, content, intellectual property, distribution, taxation, antitrust, legal liability and characteristics and quality of products and services. The adoption of any additional laws or regulations could decrease the demand for our products and services and increase our cost of doing business or otherwise harm our business or prospects. Delays in the enactment of expected regulations may result in delayed software purchasing by our customers who are subject to such regulations, which in turn may harm our business.

Moreover, the applicability to the Internet of existing laws in various jurisdictions governing issues like property ownership, sales and other taxes, libel and personal privacy is uncertain and may take years to resolve. For example, tax authorities in a number of states are currently reviewing the appropriate tax treatment of companies engaged in online commerce. New state tax regulations may subject us to additional state sales and income taxes. Any new legislation or regulation, the application of laws and regulations from jurisdictions whose laws do not currently apply to our business, or the application of existing laws and regulations to the Internet and commercial online services could harm our ability to conduct business and harm operating results.

Our products are subject to export controls, and we may be unable to obtain necessary export approvals.

Exports of software products utilizing encryption technology are generally restricted by the U.S. and various foreign governments. All cryptographic products require export licenses from certain U.S. government agencies. We have obtained approval to export products using up to 128-bit symmetric encryption and 1024-bit public key encryption, including the products formerly named IME Server, IME Desktop, IME Receive Applet, IME Remote API using OmniORB with SSL, MMS WorldWide/56 and MMS Strong WorldWide/128. We are not exporting other products and services that are subject to export control under U.S. law. However, the list of products and countries for which export approval is required, and the related regulatory policies, could be revised, and we may not be able to obtain necessary approval for the export of future products. The inability to obtain required approvals under these regulations could limit our ability to make international sales. Furthermore, competitors may also seek to obtain approvals to export products that could increase the amount of competition we face. Additionally, countries outside of the U.S. could impose regulatory restrictions impairing our ability to import our products into those countries.

Costs of communicating via the Internet could increase if access fees are imposed.

Certain local telephone carriers have asserted that the increasing popularity and use of the Internet has burdened the existing telecommunications infrastructure, and that many areas with high Internet use have begun to experience interruptions in telephone service. These carriers have petitioned the Federal Communications Commission to impose access fees on Internet service providers and online service providers. If these access fees are imposed, the costs of communicating on the Internet

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could increase substantially, potentially slowing the increasing use of the Internet. This could in turn decrease demand for our services or increase the costs of doing business.

We may have liability for Internet content.

As a provider of Internet communication products and services, we face potential liability for defamation, negligence, copyright, patent or trademark infringement and other claims based on the nature and content of the materials transmitted online. Any imposition of liability,

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particularly liability that is not covered by insurance or is in excess of insurance coverage, could be costly and could require us to implement measures to reduce exposure to this liability. This may require us to expend substantial resources or to discontinue selected service or product offerings.

We do not and cannot screen all of the content generated by users of our product but may be exposed to liability with respect to this content. Furthermore, certain foreign governments, such as Germany, have enforced laws and regulations related to content distributed over the Internet that are more strict than those currently in place in the U.S. Other countries, such as China, regulate or prohibit the transport of telephonic data in their territories. Failure to comply with regulations in a particular jurisdiction could result in fines or criminal penalties or the termination of service in one or more jurisdictions. Moreover, the increased attention focused on liability issues as a result of lawsuits and legislative proposals could impact the growth of Internet use. Liability insurance may not cover claims of these types, or may not be adequate to indemnify against all liability that may be imposed.

Interface Systems, Inc., a Tumbleweed subsidiary, is a defendant in several purported securities class action lawsuits.

On July 7, 2000, three complaints were filed by David H. Zimmer, Congressional Securities, Inc. and other plaintiffs against Interface and various additional defendants, including Interface's President and Chief Executive Officer, Robert A. Nero and Fiserv Correspondent Services, Inc., in the United States District Court for the Southern District of New York. The three cases contain substantially similar allegations of false and misleading representations by various defendants allegedly designed to inflate Interface's stock price. The complaints seek relief under the federal securities laws on behalf of purported classes of persons who purchased, held, or sold shares of Interface stock, and under various other causes of action. On September 27, 2000, we filed (i) a motion to strike or dismiss for failure to meet the certification requirements of the Private Securities Litigation Reform Act, (ii) a motion to dismiss for failure to state a claim, and (iii) a motion to dismiss because of improper venue, or in the alternative, motion to transfer the lawsuits to the Eastern District of Michigan. On July 27, 2001, the Court granted our motion to transfer the lawsuits to the Eastern District of Michigan, and left the decision on the pending motions to dismiss to the transferee Court. On April 19, 2002, the Court dismissed with prejudice plaintiffs' class allegations and federal securities law claims that purportedly arose under Section 10(b) of the Securities Exchange Act of 1934. Also on April 19, 2002, plaintiffs filed a Second Amended Consolidated Complaint that (i) consolidated the separate actions into one action; (ii) added certain new plaintiffs; (iii) withdrew Congressional Securities, Inc. ("CSI") as a plaintiff, and (iv) added claims for breach of fiduciary duty and negligent misrepresentation.

Although we believe these lawsuits are without merit, no assurance can be given about their outcome, and an adverse outcome could significantly harm our business and operating results. Moreover, the costs in defending these complaints could harm future operating results.

Internet and technology related stock prices are especially volatile and this volatility may depress our stock price.

The stock market has experienced significant price and volume fluctuations and the market prices of securities of technology companies, particularly Internet-related companies, have been highly volatile.

In the past, following periods of volatility in the market price of a company's securities, securities class action litigation has often been instituted against companies. The institution of this type of litigation against us could result in substantial costs and a diversion of our management's attention and resources, which could harm our business and prospects.

Our certificate of incorporation and bylaws contain provisions that could discourage or prevent an acquisition of Tumbleweed, which could depress our stock price.

Our certificate of incorporation and bylaws may inhibit changes of control that are not approved by our Board of Directors. These provisions could limit the price that investors might be willing to pay in the future for shares of our common stock. In particular, our certificate of incorporation provides for a classified Board of Directors and prohibits stockholder action by written consent. These provisions require advance notice for nomination of directors and stockholders' proposals. In addition, as a Delaware corporation, we are subject to Section 203 of the Delaware General Corporation Law. In general, this law prevents a person who becomes the owner of 15% or more of the

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corporation's outstanding voting stock from engaging in specified business combinations for three years unless specified conditions are satisfied. In addition, our certificate of incorporation allows our Board of Directors to issue preferred stock without further stockholder approval. This could have the effect of delaying, deferring or preventing a change in control. The issuance of preferred stock also could effectively limit the voting power of the holders of Tumbleweed common stock. The provisions of our certificate of incorporation and bylaws, as well as provisions of Delaware law, may discourage or prevent an acquisition or disposition of our business.

Future sales of common stock by our stockholders could depress our stock price.

We cannot predict if future sales of our common stock, or the availability of our common stock for sale, will depress the market price for our common stock or our ability to raise capital by offering equity securities. Sales of substantial amounts of common stock, or the perception that these sales could occur, may depress prevailing market prices for the common stock.

ITEM 3–*QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK*

We currently do not use financial instruments to hedge operating expenses in Germany, Hong Kong, Japan, the Netherlands, Switzerland, or the United Kingdom denominated in the respective local currency. As a result, our financial results could be affected by changes in foreign currency exchange rates or weak economic conditions in foreign markets. We assess the need to utilize financial instruments to hedge currency exposures on an ongoing basis.

We do not use derivative financial instruments for speculative trading purposes, nor do we hedge our foreign currency exposure in a manner that entirely offsets the effects of changes in foreign exchange rates. We regularly review our hedging program and may as part of this review determine at any time to change our hedging program.

Interest Rate Sensitivity

The primary objective of our investment activities is to preserve principal while at the same time maximizing the income we receive from our investments without significantly increasing risk. Some of the securities that we have invested in may be subject to market risk. This means that a change in prevailing interest rates may cause the fair value of the investment to fluctuate. For example, if we hold a security that was issued with a fixed rate equal to the then-prevailing interest rate and the prevailing interest rate later rises, the fair value of our investment will decline. To minimize this risk, we maintain our portfolio of cash equivalents in commercial paper and money market funds. In general, our investments are not subject to market risk because the interest paid on these funds fluctuates with the prevailing interest rate. As of March 31, 2002, none of our cash equivalents were subject to market risk.

PART II–OTHER INFORMATION

ITEM 1–*LEGAL PROCEEDINGS*

On July 7, 2000, three complaints were filed by David H. Zimmer, Congressional Securities, Inc. and other plaintiffs against Interface Systems, Inc., a company we acquired in 2000, and various additional defendants, including Interface's prior president and chief executive officer, Robert A. Nero and Fiserv Correspondent Services, Inc., in the United States District Court for the Southern District of New York. The three cases contain substantially similar allegations of false and misleading representations by various defendants allegedly designed to inflate Interface's stock price. The complaints seek relief under the federal securities laws on behalf of purported classes of persons who purchased, held, or sold shares of Interface stock, and under various other causes of action. On September 27, 2000, we filed (i) a motion to strike or dismiss for failure to meet the certification requirements of the Private Securities Litigation Reform Act, (ii) a motion to dismiss for failure to state a claim, and (iii) a motion to dismiss because of improper venue, or in the alternative, motion to transfer the lawsuits to the Eastern District of Michigan. On July 27, 2001, the Court granted our motion to transfer the lawsuits to the Eastern District of Michigan, and left the decision on the pending motions to dismiss to the transferee Court. On April 19, 2002, the Court dismissed with prejudice plaintiffs'

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class allegations and federal securities law claims that purportedly arose under Section 10(b) of the Securities Exchange Act of 1934. Also on April 19, 2002, plaintiffs filed a Second Amended Consolidated Complaint that (i) consolidated the separate actions into one action; (ii) added certain new plaintiffs; (iii) withdrew Congressional Securities, Inc. ("CSI") as a plaintiff, and (iv) added claims for breach of fiduciary duty and negligent misrepresentation.

Although we believe these lawsuits are without merit, no assurance can be given about their outcome, and an adverse outcome could significantly harm our business and operating results. Moreover, the costs in defending these complaints could harm future operating results.

On May 7, 2002 we sued PayPal, Inc. alleging infringement of our U.S. Patent No. 5,790,790 and our U.S. Patent No. 6,192,407.

ITEM 2–*CHANGES IN SECURITIES AND USE OF PROCEEDS*

On August 1, 2000, we completed a primary and secondary public offering of 3,000,000 shares of our common stock at a price of $56.00 per share. Of the 3,000,000 shares of common stock, 1,500,000 primary shares were sold by Tumbleweed and 1,500,000 secondary shares were sold by stockholders of Tumbleweed. We did not receive any of the proceeds from shares sold by our stockholders. We received net proceeds of $77.6 million from the offering of primary shares. For the quarter ended March 31, 2002, the net capital was used for working capital and general corporate purposes. Remaining proceeds were predominantly held in cash and cash equivalents.

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, hereunto duly authorized:

TUMBLEWEED COMMUNICATIONS CORP.

Date: May 14, 2002	By:	/s/ JEFFREY C. SMITH Jeffrey C. Smith *Chairman of the Board and Chief Executive Officer (Principal Executive Officer)*
Date: May 14, 2002	By:	/s/ ELIZABETH D. JORDAN Elizabeth D. Jordan *Senior Vice President-Finance and Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)*

QuickLinks

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TUMBLEWEED COMMUNICATIONS CORP. INDEX
TRADEMARKS
PART I–FINANCIAL INFORMATION
ITEM 1– FINANCIAL STATEMENTS
TUMBLEWEED COMMUNICATIONS CORP. AND SUBSIDIARIES Condensed Consolidated Balance Sheets (in thousands)
TUMBLEWEED COMMUNICATIONS CORP. AND SUBSIDIARIES Condensed Consolidated Statements of Operations (in thousands, except per share data) (unaudited)
TUMBLEWEED COMMUNICATIONS CORP. AND SUBSIDIARIES Condensed Consolidated Statements of Cash Flows (in thousands) (unaudited)
TUMBLEWEED COMMUNICATIONS CORP. AND SUBSIDIARIES Notes to Condensed Consolidated Financial Statements
ITEM 2– MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
ITEM 3– QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK
PART II–OTHER INFORMATION
ITEM 1– LEGAL PROCEEDINGS
ITEM 2– CHANGES IN SECURITIES AND USE OF PROCEEDS
SIGNATURES

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