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# SECURITIES & EXCHANGE COMMISSION EDGAR FILING

## Form: 10-K

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

**Form 10-K**

**☑Annual Report under Section 13 or 15(d) of the Securities Exchange Act of 1934**

**For the fiscal year ended December 31, 2009**

**or**

**❑Transitional Report under Section 13 or 15(d) of the Securities Exchange Act of 1934**
**1-32146**

Commission file number

**DOCUMENT SECURITY SYSTEMS, INC.**

(Exact name of Registrant as specified in its charter)

| **New York** | **16-1229730** |
|---|---|
| (State of incorporation) | (IRS Employer Identification Number) |

**First Federal Plaza**
**28 East Main Street, Suite 1525**
**Rochester, New York 14614**

(Address of principal executive office)

**(585) 325-3610**

(Registrant's telephone number)

**Securities registered under Section 12(b) of the Act:**

| Title of each class | Name of each exchange on which registered |
|---|---|
| **Common Stock (Par Value - $0.02)** | **NYSE Amex Equities** |

**Securities registered under to Section 12(g) of the Act:**

Indicate by check mark if the registrant is a well-known seasoned issuer as defined in Rule 405 of the Securities Act
YES ❑ NO ☑
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act.
YES ❑ NO ☑

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ❑

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.

Large Accelerated Filer ❑ Accelerated Filer ❑ Non-Accelerated Filer ❑ Smaller Reporting Company ☑

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

The aggregate market value of the stock held by non-affiliates (11,030,754 shares) computed by reference to the closing price of such stock ($1.90), as of June 30, 2009, was $20,958,000.

As of March 19, 2010, there were 17,760,324shares of Common Stock of Document Security Systems, Inc. issued.

**DOCUMENTS INCORPORATED BY REFERENCE**

The definitive proxy statement relating to the registrant's Annual Meeting of Stockholders, to be held on May 18, 2010, is incorporated by reference into Part III of this Form 10-K to the extent described therein.

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## ITEM 1 - BUSINESS

### Overview

Document Security Systems, Inc. (referred to in this report as "Document Security," "DSS," "we," "us," "our" or "Company") develops, markets, manufactures and sells paper and plastic products designed to protect valuable information from unauthorized scanning, copying, and digital imaging. We have developed security technologies that are applied during the normal printing process and by all printing methods including traditional offset, gravure, flexo, digital or via the internet on paper, plastic, or packaging. Our technologies and products are used by federal, state and local governments, law enforcement agencies and are also applied to a broad variety of industries as well, including financial institutions, high technology and consumer goods, entertainment and gaming, healthcare/pharmaceutical, defense and genuine parts industries. Our customers use our technologies where there is a need for enhanced security for protecting and verification of critical financial instruments and vital records, or where there are concerns of counterfeiting, fraud, identity theft, brand protection and liability.

We were organized as a New York corporation in 1984, and in 2002, chose to strategically focus on becoming a developer and marketer of secure technologies for all forms of print media. To accomplish this, we acquired Lester Levin, Inc, an operator of a small printing company called Patrick Printing and an Internet-based business called Legalstore.com, and Thomas M. Wicker Enterprises, Inc. and Document Security Consultants, Inc., two privately owned companies engaged in the document security technology business with rights to certain patents developed by certain members of the Wicker Family. As a result of these acquisitions, we compiled the basis of our document security business by combining basic print capabilities necessary for research and development with the knowledge and expertise of our team of printing professionals and a foundation of patented technologies and trade secrets from which to launch our product offerings. Since this early stage, we have focused our efforts on developing and in some cases patenting new technologies and products, building our corporate, operational, marketing and sales staff to accommodate our expected growth, and developing and implementing our patent and intellectual property protection strategy. In September 2007, we sold certain assets and the operations of Patrick Printing to a private company, as this operation no longer supported our core industry focus. In October 2009, we sold the assets and liabilities associated with our Legalstore.com business in exchange for common stock of Internet Media Services, Inc., in order to concentrate our efforts on the security and printing segments of our Company.

In December 2004, the Company entered into an agreement with the Wicker Family in which Document Security Systems obtained the legal ownership of technology (including patent ownership rights) previously held by the Wicker Family. At that time, the agreement with the Wicker Family provided that the Company would retain 70% of the future economic benefit derived from settlements, licenses or subsequent business arrangements from any infringer of the Wicker patents that Document Security Systems chooses to pursue. The Wicker Family was to receive the remaining 30% of such economic benefit. In February 2005, the Company further consolidated its ownership of the Wicker Family based patents and its rights to the economic benefit of infringement settlements when the Company purchased economic interests and legal ownership from approximately 45 persons and entities that had purchased various rights in Wicker Family technologies over several decades.

In August 2005, the Company commenced a suit against the European Central Bank ("ECB") alleging patent infringement by the ECB and claimed unspecified damages. We brought the suit in the European Court of First Instance in Luxembourg. We alleged that all Euro banknotes in circulation infringe the Company European Patent 0 455 750B1 (the "Patent"), which covers a method of incorporating an anti-counterfeiting feature into banknotes or similar security documents to protect against forgeries by digital scanning and copying devices. Commencing in March 2006, the ECB countersued in eight national courts that the Patent was invalid. To date, the most significant events in the case since it was filed have been the challenges of patent validity by the ECB. To date, there have been four adverse rulings and two positive rulings in regard to the patent's validity. Through August 2008, the Company spent approximately $4.2 million dollars on legal, expert and consulting fees for its case. In August 2008, the Company decided to reduce its cost burden from the case and entered into an agreement with Trebuchet Capital Partners, LLC ("Trebuchet") under which Trebuchet agreed to pay substantially all of the litigation costs associated with pending validity proceedings and future validity and future patent infringement suits filed against the ECB and certain other alleged infringers of the Patent in exchange for 50% of any future proceeds or settlements associated with the litigation.

In addition to its patent defense efforts, since 2002, the Company has also worked to develop and expand its patent and product portfolio. As of March 22, 2010, we have 14 patents and have 57 patent applications in process, including provisional and PCT patent applications and applications that have entered the National Phase in various countries including the United States, Canada, Europe, Japan, Brazil, Israel, Mexico, Indonesia and South Africa. These applications cover our technologies, including our AuthentiGuard® On-Demand, AuthentiGuard® Prism™, AuthentiGuard® Phantom™, AuthentiGuard® ObscuraScan™, AuthentiGuard® Survivor 21™, AuthentiGuard® VeriGlow™ products, and several other anti-counterfeiting and authentication technologies in development. The Company believes that its commitment to research and development is critical to its position as a leading provider of anti-counterfeiting solutions to our customers.

Prior to 2006, the Company's primary revenue source in its document security division was derived from the licensing of its technology. The Company had limited production capabilities. In 2006, the Company began to expand its ability to be a provider of anti-counterfeiting products that utilize the Company's anti-counterfeiting technologies. In 2006, we acquired San Francisco-based Plastic Printing Professionals, Inc. ("P3"), a privately held plastic cards manufacturer located in the San Francisco, CA area. P3's primary focus is manufacturing long-life composite, laminated and surface printed cards which can include magnetic stripes, bar codes, holograms, signature panels, invisible ink, micro fine printing, guilloche patterns, Biometric, RFID and a patent-pending watermark technology. P3's products are marketed through an extensive broker network that covers much of North America, Europe and South America and by manufacturing for various industry integrators.

In December 2008, we acquired substantially all of the assets of DPI of Rochester, LLC, ("DPI")a privately held commercial printer located in Rochester, NY. We formed a new subsidiary called DPI Secuprint to incorporate this new company which significantly improved our ability to produce our security paper products as well as improving our competitiveness in the market for custom security printing, especially in the areas of vital records, secure coupons, transcripts, and prescription paper along with the ability to offer our customers a wider range of commercial printing offerings.

In 2009, we generated revenue of $9.9 million in 2009, a 49% increase compared to 2008. The increase was primarily due to the acquisition of DPI in December of 2008. The increase caused by the acquisition of DPI more than offset decreases experienced by the Company's other divisions, Document Security Systems and P3, and the loss of revenue as a result of the Company's divestiture of its legal products division in October of 2009. All of the Company's divisions experienced sales declines which the Company believes were the direct result of the widespread global economic recession that occurred during the first six months of 2009, and the lingering effects of the deep recession during the last half of 2009. During 2009, the Company experienced a net loss of $4.0 million, a 52% decrease from a net loss of $8.3 million in 2008. During 2009, the Company was able to offset the effects of less than forecasted revenues with significant cost reductions that will allow the Company to reach cash flow and net income breakeven at sales levels consistent with the historical demand at each of its divisions, which the Company believes will occur as general global economic levels recover from the recession.

On February 12, 2010, the Company acquired Premier Packaging Corporation, a privately held packaging company located in the Rochester NY area. Premier Packaging Corporation is an ISO 9001:2008 registered manufacturer of custom paperboard packaging serving clients in the pharmaceutical, beverage, photo packaging, toy, specialty foods and direct marketing industries, among others. The Company expects the acquisition will allow it to introduce anti-counterfeiting products to the packaging market that further expands the usage of its technologies. The Company believes that the ability to deter and prevent counterfeiting of brand packaging will provide major benefits to companies around the globe who are affected by product counterfeiting.

**Our Core Products, Technology and Services**

Our core business is counterfeit prevention, brand protection and validation of authentic print media, including government-issued documents, aerospace industry spare parts documents, packaging, ID Cards, licenses and more. We are a leader in the research and development of optical deterrent technologies and have commercialized these technologies with a suite of products that offer our customers an array of document security solutions. We provide document security technology to security printers, corporations, consumer product companies and governments worldwide and for currency, identifications, certifications, travel documents, prescription and medical forms, consumer product and pharmaceutical packaging, and school transcripts.

Our products can be delivered on paper, plastic, or digitally via our AuthentiGuard® DX™ product suite. We believe that our continued efforts in the field of digital security and technology greatly expands the reach and potential market for our AuthentiGuard® DX™ digital products and enterprise solutions. We believe that our AuthentiGuard® DX™ solution significantly changes the economics of document security for many customers as it eliminates the requirement to utilize pre-printed forms while allowing customers to leverage existing investments in their information technology infrastructure.

*Technologies*

We have developed or acquired over 30 technologies that provide to our customers a wide spectrum of solutions.

According to a March 2010 report by the MDB Capital Group LLC, an institutional research and investment banking firm, located in Santa Monica, California that focuses exclusively on companies that possess market changing, disruptive intellectual property, has DSS ranked among the top companies in intellectual property leadership based on several proprietary intellectual property indexes.

DSS ranks in the 90th percentile from over 4,000 companies for IP leadership as defined by a high patent citation (Companies citing the Company's Patents in their patent applications) number of 2.12 which is two times higher than its peer group. The Company also has a 40.38 PV Ratio which indicates that the Company's stock market value is lower than its patent value according to the MDB's PatentVest evaluation methodology.

The company's primary anti-counterfeiting products and technologies are marketed under the following trade names:

- **AuthentiGuard™ DX™** is a networked appliance that allows the author of any Microsoft Office document (Outlook, Word, Excel, or PowerPoint) to secure nearly any of its alphanumeric content when it is printed or digitally stored. AuthentiGuard® DX prints selected content using the company's patented technology so that it cannot be read by the naked eye. Reading the hidden content, or authenticating the document is performed with a proprietary viewing device or software.

  Like AuthentiGuard® DX™**, AuthentiGuard® On -Demand™** is a customized software or a web-based application that incorporates the verification feature of AuthentiGuard® Prism™ and the anti-copy anti-scan features of AuthentiGuard® Pantograph 4000™ in a manner that makes those technologies printable from desktop printers and digital presses worldwide. On-Demand™ provides the ability to produce highly secure documents virtually "any-time, anywhere", and is highly effective in variable data applications.

- **AuthentiGuard® Laser Moiré™,** a counterfeit deterrent technology, prevents counterfeit reproductions by creating gross distortions and unmistakable moiré interference patterns throughout the image. Verification of original documents or images is fast and easy with The Authenticator – our proprietary lens that reveals the moiré pattern. The technology is embedded into an image that requires protection from duplication and theft, such as photographs, portraits, currency, driver's licenses, postage stamps, tickets, labels, brand packaging, or documents.

- **AuthentiGuard® Prism™,** a verification technology, embeds hidden words, images, or logos using 2-color or 4-color processes that are only visible using a special, non-public proprietary Prism™ lens that reveals hidden Prism™ images. We believe that the hidden words, images or logos embedding with the Prism™ technology cannot be reproduced with even the most sophisticated digital copiers or scanners. As a result, the absence of the hidden words, images or logos alerts the end-user that the document is counterfeit. The AuthentiGuard® Prism technology protects verification forms such as spare parts, packing slips, checks, currency, licenses, travelers' checks, postage stamps, legal documents, tickets, labels, and brand packaging.

- **AuthentiGuard® Pantograph 4000™**, a counterfeit deterrent technology, provides what we believe is the most powerful, patented pantograph technology ever created. Hidden words such as "VOID" or "COPY", company logos, or designs appear when a document utilizing the technology is photocopied or scanned, preventing unauthorized duplication. Although there are other versions of this technology being sold by competitors, we believe that no version other than our Pantograph 4000™ defeats high and low resolution scanners and produces crisp clear and readable warning words. We believe that virtually any printable surface can utilize the technology, including paper, Teslin, PVC, Tyvek and cardboard packaging. This technology has been used for gift certificates, school transcripts, coupons, tickets, checks, packing slips, receipts, schematic drawings, plans, music, scripts, training manuals, business plans, internal memos, letterhead, legal forms and prescription pads.

- **AuthentiGuard® Phantom™,** a verification technology, uses "tilt-to-reveal" hidden images or words that can be easily viewed without special equipment. Viewed straight on, the hidden images are virtually invisible to the naked eye, but when the package or document is viewed at an angle, the hidden images are clearly revealed. For added security, we believe that our patented AuthentiGuard® Phantom™ technology cannot be reproduced with even the best copiers or scanners. We also feel that this technology is much more effective and eye catching then color shifting ink.

- **AuthentiGuard® VeriGlow™,** a verification technology, is a two-tiered, customized document security systems that utilizes unique photosensitive inks and incorporates embedded hidden messages or images that are only viewable with a special light source and our special non-public proprietary Veri-Glow reading device. This patent pending technology can be applied during the printing process or it can be applied to pre-printed items and is useful in the protection of vital records such as passports, documents, brand protection, packaging and currency.

- **AuthentiGuard® Survivor 21®,** a counterfeit deterrent technology, protects printed checks from duplication via digital copiers and scanners while providing a patent-pending security feature that survives the background dropout that results from bank's archival scan. Survivor 21™ was created to meet new government banking regulations that require documents to be archive-scan friendly, without compromising security.

- **AuthentiGuard® Block-Out™**, a counterfeit deterrent technology, also called the "anti-color reproduction system", makes it very difficult to reproduce protected documents on digital color copiers. Certain copiers recognize Block-Out's embedded graphics on the original document, and print out solid black sheets or highly distorted images. AuthentiGuard® Block-Out™ is our own unique proprietary graphic design that is recognized and triggers a mechanism developed by Omron Corporation in some copiers. We developed it to prevent color copiers and photo processors from replicating any image or document that contains our custom Block-Out™ graphics. This technology can be integrated into highly sensitive government documents such as currency, car titles, passports and licenses as well as checks, travelers' checks, postage stamps, photographs, original art and brand packaging.

- **AuthentiGuard® MicroPerf™,** a verification technology, creates a verifier mark that is invisible to the naked eye when viewed under normal circumstances and unnoticeable to the touch, but can be viewed by simply holding the document up to a normal light for fast and easy authentication. MicroPerf™ uses a laser to insert fine perforations into the document, and can be placed on vital records, documents, packaging or currency and is a micro-sized perforation in the shape of a word or image that cannot be removed or altered in any way.

*Products and Services*

**Generic Security Paper**: Our primary product for the retail end-user market is AuthentiGuard® Security Paper. AuthentiGuard® Security Paper is blank paper that contains our Pantograph 4000™ technology. The paper reveals hidden warning words, logos or images using The Authenticator- our proprietary viewing lens – or when the paper is faxed, copied or scanned. The hidden words appear on the duplicate or the computer digital file and essentially prevent documents, including forms, coupons and tickets, from being counterfeited. We market and sell our AuthentiGuard® Security Paper primarily through several major paper distributors such as Boise Cascade and Blanks USA. Since 2005, Boise has marketed our AuthentiGuard® Security Paper under its Boise Beware brand name in North America, primarily through its commercial paper sales group. Blanks USA sells and manufactures the technology under the "Kant Kopy" brand name. The company also sells its security paper on the internet utilizing a ecommerce website, www.protectedpaper.com. We retain the rights to sell the AuthentiGuard® Security Paper directly to end-users anywhere in the world. The company also had a version of its security paper tested and certified for use on Hewlett Packard ("HP") Indigo Digital presses by the Rochester Institute of Technology's Printing Applications Laboratory. This certification allows the Company's security paper to be marketed to HP Indigo users worldwide.

**Security and non-security printing**: Our technology portfolio allows us to create unique custom secure paper, plastic, packaging and Internet-based and software enterprise solutions. We market and sell to end-users that require anti-counterfeiting and authentication features in a wide range of printed materials such as documents, vital records, prescription paper, driver's licenses, birth certificates, receipts, manuals, identification materials, entertainment tickets, secure coupons, parts tracking forms, as well as product packaging including pharmaceutical and a wide range of consumer goods. In addition, we provide a full range of digital and large offset commercial printing capabilities to our customers.

Since our inception, we have primarily outsourced the production of the majority of our custom security print orders to strategic printing vendors. In December 2008, we acquired a commercial printer with long-run offset and short run digital printing capabilities that will allow us to produce the majority of our security print orders in-house. We produce our plastic printed documents such as ID cards, event badges, and driver licenses at our manufacturing facility in Brisbane, California under the name Plastic Printing Professionals. In late 2007, we moved our P3 manufacturing facility to a 25,000 square foot facility in order to increase our plastic manufacturing capacity, and during 2008, we upgraded their production capabilities by adding equipment that will improve its productivity, along with equipment for high speed data encoding and equipment that for productions of high-volume precision RFID cards.

**Digital Security Solutions:** Using software that we have developed, we can electronically render several of our technologies digitally to extend the use of optical security to the end-user of sensitive information. With our AuthentiGuard**® DX™** we market a networked appliance that allows the author of any Microsoft Office document (Outlook, Word, Excel, or PowerPoint) to secure nearly any of its alphanumeric content when it is printed or digitally stored. AuthentiGuard® DX prints selected content using DMC'S patented technology so that it cannot be read by the naked eye. Reading the hidden content, or authenticating the document is performed with a proprietary viewing device or software.

The company has developed an internet delivered technology called AuthentiGuard® – On Demand™ where information is hidden and then verified utilizing a inexpensive viewing glass. This technology is currently being utilized by a Central American country for travel visas.

The company has also developed digital versions of its AuthentiGuard® – Prism™ and AuthentiGuard® – Pantograph 4000™ technologies which are produced on HP Indigo Presses, Canon Color Copiers, Ricoh Color Copiers and Konica Desktop Printers. The company sells the digital products directly through its internal sales force and it has also entered a contract to sell its digital solutions through a third party who specializes in hardware software engineering solutions.

**Technology Licensing:** We license our anti-counterfeiting technology and trade secrets to security printers through licensing arrangements. We seek licensees that have a broad customer base that can benefit from our technologies or have unique and strategic capabilities that expand the capabilities that we can offer our potential customers Licenses can be for a single technology or for a package of technologies. We offer licensees a variety of pricing models, including:

- Pay us one price per year;
- Pay us a percentage of gross sales price of the product containing the technology during the term; or
- Joint venture or profit sharing arrangement
- Pay Per Finished Piece

**Legal Products**: We also owned and operated Legalstore.com, an Internet company which sells legal supplies and documents, including security paper and products for the users of legal documents and supplies in the legal, medical and educational fields. On October 8, 2009 we sold the assets and liabilities associated with our Legalstore.com business in exchange for 7,500,000 shares of common stock of Internet Media Services, Inc., representing approximately 37% of the outstanding shares of the newly formed company.

**Intellectual Property**

*Patents*

Our ability to compete effectively depends in part on our ability to maintain the proprietary nature of our technology, products and manufacturing processes. We principally rely upon patent, trademark, trade secrets and contract law to establish and protect our proprietary rights. During our development, we have expended a significant percentage of our resources on the research and development to ensure that we are a market leader the ability to provide our customers effective solutions against a never changing array of counterfeit risks.

Based largely on these efforts, we currently fourteen patents and have 57 patent applications in process, including provisional and PCT patent applications and applications that have entered the National Phase in various countries including the United States, Canada, Europe, Japan, Brazil, Israel, Mexico, Indonesia and South Africa. These applications cover our technologies, including our AuthentiGuard® On-Demand, AuthentiGuard® Prism™, AuthentiGuard® Phantom™, AuthentiGuard® ObscuraScan™, AuthentiGuard® Survivor 21™, AuthentiGuard® VeriGlow™ products, and several other anti-counterfeiting and authentication technologies in development.

We also jointly have the rights to Patent No. 5,707,083 with R.R. Donnelly. Under the terms of our agreement with R.R. Donnelly, it has no rights in any revenue generated by us through the technology represented by the patent. R.R. Donnelly may license the technology but is required to split any revenue with us after costs associated with any licensing.

In addition to our current patent activities, we own several patents that we acquired in 2002 when we acquired companies owned by various members of the Wicker Family and The Estate of Ralph Wicker, including US Patents 5,018,767, European Patent 0455750, Canadian Patent 2,045,580, and a 50% ownership of US Patent No 5,735,547 (collectively, the "Wicker Patents"). However, due to previous contractual agreements associated with the Wicker Patents, we did not obtain certain economic rights to these patents, including certain economic rights to benefits derived from settlements, licenses or other subsequent business arrangements from any person or entity that had been proven to infringe these patents. Therefore, to consolidate our ownership and economic rights to the Wicker Patents, we entered into the following transactions.

- In 2004, we entered into an agreement with The Estate of Ralph Wicker and its assigns to purchase from them the right to 70% of the future economic benefit derived from settlements, licenses or subsequent business arrangements from any infringer of the Wicker Patents that we choose to pursue, with The Estate of Ralph Wicker receiving the remaining 30% of such economic benefit.

- In February 2005, we further consolidated our ownership of the Wicker Patents by purchasing the economic interests and ownership from 45 persons and entities that had purchased various rights in Wicker Family technologies, including the Wicker Patents. As a result of this transaction, we increased our ownership of US Patent 5,735,547 to 100%, and increased to our right to future economic benefits to the Wicker Patents to approximately 86% of all settlements or license royalties derived from, among other things, infringement suits related to the foreign Wicker Patents, including European Patent 0455750. Pursuant to these transactions, we issued an aggregate of 541,460 shares to of our Common Stock, valued at approximately $3.9 million.

On August 20, 2008, the Company entered into an agreement with Trebuchet Capital Partners, LLC ("Trebuchet") under which Trebuchet has agreed to pay substantially all of the litigation costs associated with pending validity proceedings initiated by the European Central Bank ("ECB") in eight European countries relating to the Company's European Patent 0 455 750B1 that the Company has claimed the ECB infringed in printing of the Euro currency (the "Patent"). Trebuchet also agreed to pay substantially all of the litigation costs associated with future validity challenges filed by the ECB or other parties, provided that Trebuchet elects to assume the defense of any such challenges, in its sole discretion, and patent infringement suits filed against the ECB and certain other alleged infringers of the Patent, all of which suits may be brought at the sole discretion of Trebuchet and may be in the name of the Company, Trebuchet or both. The Company provided Trebuchet with the sole and exclusive right to manage infringement litigation relating to the Patent in Europe, including the right to initiate litigation in the name of the Company, Trebuchet or both and to choose whom and where to sue, subject to certain limitations set forth in the agreement. Under the terms of the Agreement, the Company and Trebuchet have agreed to equally share all proceeds generated from litigation relating to the Patent, including judgments and licenses or other arrangements entered into in settlement of any such litigation. Trebuchet is also entitled to recoup any litigation expenses specifically awarded to the Company in such actions.

By aggressively defending our intellectual property rights, we believe that we may be able to secure a potentially significant amount of additional and ongoing revenue by securing proceeds from lawsuits, settlements, or licensing agreements with those persons, companies or governments that we believe are infringing our patents. We intend to use the appropriate legal means that are economically feasible to protect our ownership of these technologies. We cannot be assured, however, that our efforts to prevent the misappropriation of the intellectual property used in our business will be successful, or that we will be successful in obtaining monetary proceeds from entities that we believe are infringing our patents. Further, we cannot be assured that any patents will be issued for our U.S. or foreign applications or that, if issued, they will provide protection against competitive technologies or will be held valid and enforceable if challenged. We also cannot be assured that competitors would not be able to design around any such proprietary right or obtain rights that we would need to license or design around in order to practice under these patents.

*Trademarks*

We have registered our "AuthentiGuard" mark, as well as our "Survivor 21" electronic check icon with the U.S. Patent and Trademark Office. A trademark application is pending in Canada for "AuthentiGuard." AuthentiGuard® is registered in several European countries including the United Kingdom.

*Research and Development*

Our research and development costs consist primarily of compensation costs for research personnel and direct costs for the use of third-party printers' facilities to test and develop our technologies on equipment that we do not have access to internally. We focus our research efforts on creating anti-counterfeiting solutions and products for current and anticipated customer needs. Furthermore, we often seek patent or trademark protection on our developments.

**Major Customers**

During 2009, two customers accounted for 19% and 12% of the Company's total revenue, respectively. As of December 31, 2009, two customer account receivable balances accounted for 21% and 17% of the Company's trade accounts receivable balance, respectively. During 2008, two customers accounted for 11% and 10% of the Company's total revenue from continuing operations, respectively. As of December 31, 2008, one customer account receivable balance that was acquired as part of the Company's acquisition of the assets of a commercial printer in December 2008, accounted for 42% of the Company's trade accounts receivable balance.

**Websites**

We maintain the website, www.documentsecurity.com, which describes our patented document security solutions, our targeted vertical markets, company history, and offers our security consulting services. We also maintain www.plasticprintingprofessionals.com, which describes our ID card and other plastic and vinyl printing services. In addition, we maintain the website www.protectedpaper.com, an e-commerce site that markets and sells our patented security papers hand-held security verifiers and custom security documents to end users worldwide. We also utilize www.authenticate-360.com, a website which is hosted and owned by our licensee, The Ergonomic Group; this website is a source for counterfeiting information and promotion of our On-Demand™ products. In addition, we market digital and large offset commercial printing at our subsidiaries website: www.dpirochester.com. In February 2010, we acquired Premier Packaing Corp, which maintains the website www.premiercustompkg.com. In addition to the active websites, the company owns over 40 domain names for future use or for strategic competitive reasons.

**Competition**

Currently, the security print market is comprised of a few very large companies and an increasing number of small companies with specific technology niches. The expansion of this market is the result of increasing requirements for national security, as well as the proliferation of brand and identity theft. Counterfeiting has expanded significantly as advancing technologies in digital duplication and scanning combined with increasingly sophisticated design software has enabled easier reproduction of originals.

Our industry is highly fragmented and characterized by rapid technological change and product innovations and evolving standards. We feel a consolidation of the industry may transpire in the near future as larger, well financed companies acquire smaller technology companies to position themselves in the industry and access their intellectual property and access to client lists. Many of our current competitors have longer operating histories, more established products, greater name recognition, larger customer bases, and greater financial, technical and marketing resources. As a result, our competitors may be able to adapt more quickly to new or emerging technologies and changes in customer requirements, and devote greater resources to the promotion and sale of their products. Competition may also force us to decrease the price of our products and services. There is no assurance that we will be successful in developing and introducing new technology on a timely basis, new products with enhanced features, or that these products, if introduced, will enable us to establish selling prices and gross margins at profitable levels.

Although our technology is effective primarily on analog and digital copiers and scanners, our competition covers a wide array of document security and anti-counterfeiting solutions. We conduct research and development to improve our technology, including the development of new patents and trade secrets. We will rely primarily upon our patents and trade secrets to attempt to thwart competition, although there can be no assurance that we will be successful.

Our competitors include Standard Register Company, which specializes in printing security technologies for the check and forms and medical industries; De La Rue Plc, that specializes in printing secure currency, tickets, labels, lottery tickets and vital records for governments and Fortune 500 companies; Xerox, an industry leader in copying and scanning that has made recent entries into the anti-counterfeiting business and has a competing Safety Paper product called "X Void." Our P3 ID card manufacturing operation competes with LaserCard Corporation which supplies advanced ID technology to the U.S. federal government and other government programs worldwide, with a range of products and solutions that includes secure ID technologies.

In addition, other competing hidden word technologies are being marketed by competitors such as NoCopi Technologies which sells and markets secure paper products, and Graphic Security Systems Corporation, which markets scrambled indicia.

Digital watermarks, RFID and biometric technologies are also being introduced into the marketplace by Digimarc Corporation, IBM and L-1 Identity Solutions. These digital protection systems require software and hardware such as scanners and computers to implement and utilize the technology and, consequently, this technology must be utilized in a controlled environment with the necessary equipment to create the verification process. Therefore, versions of our optical security technologies do not require hardware and software to operate and therefore, provide a power outage fail-safe when combined or layered with RFID, digital watermarks or biometric systems.

Large Office Equipment Manufacturers, called OEMs, such as Sharp, Canon, Ricoh, Hewlett Packard and Eastman Kodak are developing “smart copier” technology that recognizes particular graphical images and produces warning words or distorted copies. Some of the OEMs are also developing user assigned and variable pantograph “hidden word” technologies in which users can assign a particular hidden work in copy, such as “void” that is displayed when copy of such document is made.

Optical Deterrent features such as ours are utilized mainly by the large worldwide security printers for the protection of currency. Many of these features such as micro-printing were developed pre-1980 as they were designed to be effective on the imaging devices of the day which were mainly photography mechanisms. With the advent of modern day scanners, digital copiers, digital cameras and easy to use imaging software such as Adobe Photoshop many of the pre-1980 optical deterrents such as micro-printing are no longer or much less effective in the prevention of counterfeiting.

Unlike some of our competitors, our technologies are developed to defeat today’s modern imaging systems. Almost all of our products and processes are built to thwart scanners and digital copiers and we believe that our products are the most effective in doing so in the market today. In addition, our technologies do not require expensive hardware or software add-ons to authenticate a document, but instead require simple, inexpensive hand-held readers which can be calibrated to particular hidden design features. Our technologies are literally ink on paper that is printed with a particular method to hide selected things from a scanner’s “eye” or distort what a scanner “sees.” These attributes make our anti-scanning technologies very cost effective versus other current offerings on the market since our technologies are imbedded during the normal printing process, thereby significantly reducing the costs to implement the technologies.

The commercial printing industry in the US includes around 35,000 companies with $90 billion of annual revenue. (Source: http://www.firstresearch.com/industryanalysis/commercialprinting.html). Several giants like RR Donnelley and Canadian printer Quebecor World have multibillion revenues, but most printers considered "large" have annual revenues under $1 billion. The majority of commercial printers are small or midsized businesses that operate one production plant, employ fewer than 20 people, and have annual revenue under $5 million. Despite continuing consolidation, the industry is highly fragmented; the largest 50 companies hold only about 30 percent of the market. We compete primarily with locally-based printing companies in the Rochester and Western New York markets. Most of our competitors in these markets are privately-held, single location operations.

In the packaging industry, we compete with a significant number of national, regional and local companies, many of which are independent and privately-held. The largest competitors in this market are primarily focused on the long-run print order market. They include large integrated paper companies such as Rock-Tenn Company, Caraustar Industries, Inc., Graphic Packaging Holding Company and Mead Westvaco.

In general, changes in prevailing U.S. economic conditions significantly impact the general commercial printing industry. To the extent weakness in the U.S. economy causes local and national corporations to reduce their spending on advertising and marketing materials, the demand for commercial printing services may be adversely affected.

**Segment Information**

We operate through two segments:

- **Security and commercial printing**. This segment consists of the license, manufacture and sale of document security technologies, including digital security print solutions and secure printed products at Document Security Systems and P3 divisions, along with commercial printing provided by P3 and DPI Secuprint.

- **Legal Supplies**. Sale of specialty legal supplies, primarily to lawyers and law firms located throughout the United States as Legalstore.com. During the fourth quarter of 2009, the Company sold its legal products business. The Company continues to report the results as continued operations because the operations and cash flows of the component have not been eliminated and given the Company’s continued involvement after the sale.

Financial information regarding these segments is provided in Note 15 to our consolidated financial statements included in this Annual Report on Form 10-K.

**Employees**

As of December 31, 2009, we had 80 full and part-time employees. In February 2010, we added 32 employees as the result of our acquisition of Premier Packaging Corp. It is important that we continue to retain and attract qualified management and technical personnel. Our employees are not covered by any collective bargaining agreement, and we believe that our relations with our employees are good.

**Government Regulation**

In light of the events of September 11, 2001 and the subsequent war on terrorism, governments, private entities and individuals have become more aware of, and concerned with, the problems related with counterfeit documents. Homeland Security remains a high priority in the United States. This new heightened awareness may result in new laws or regulations which could impact our business. We believe, however, that any such laws or regulations would be aimed at requiring or promoting anti-counterfeiting, and therefore would likely have a positive impact on our business plans.

Document Security Systems plays an active role with the Document Security Alliance group, as it sits on various committees and has been involved in design recommendations for important U.S. documents. This group of security industry specialists was formed by the U.S. Secret Service to evaluate and recommend security solutions to the Federal government for the protection of credentials and vital records.

As counterfeiting continues to increase worldwide, various new laws and mandates are occurring to address the growing security problem which we believe will increase our ability to generate revenue. For example, in 2007 Federal legislation was enacted that required hospitals, physicians and pharmacies to use tamperproof paper to fill all Medicaid prescriptions. Initially, the requirement, which was part 7002(b) of the “U.S. Troop Readiness, Veterans’ Care, Katrina Recovery and Iraq Accountability Appropriations Act of 2007”, was effective April 1, 2008.

**ITEM 1A – RISK FACTORS**

An investment in our securities is subject to numerous risks, including the Risk Factors described below. Our business, operating results or financial condition could be materially adversely affected by any of the following risks. The risks described below are not the only ones we face. Additional risks we are not presently aware of or that we currently believe are immaterial may also materially affect our business. The trading price of our Common Stock could decline due to any of these risks. In assessing these risks, you should also refer to the other information contained or incorporated by reference in this Form 10-K, including our financial statements and related notes, competition and intellectual property.

***We have a history of losses and we may experience losses in the foreseeable future.***

We have not achieved profitability and we may incur losses for the foreseeable future. In fiscal 2009, 2008, and 2007, we incurred losses of approximately $4.0 million, $8.3 million, and $7.0 million, respectively. As of December 31, 2009, our accumulated deficit was $36.5 million, which represents our net losses since inception. We will need to achieve incremental revenue growth and manage our costs to achieve profitability. Even if we do achieve profitability, we may be unable to sustain profitability on a quarterly or annual basis thereafter. It is possible that our revenue will grow at a slower rate than we anticipate or that operating expenses will increase beyond our current run rate. The current global economic slowdown could slow customer orders, as well as anticipated revenue growth, and could further delay our prospects for operating profitability.

***Due to our low cash balance and negative cash flow, we may have to further reduce our costs by curtailing future operations to continue as a business.***

We have incurred significant net losses in previous years. Our ability to fund our capital requirements out of our available cash and cash generated from our operations depends on a number of factors. Some of these factors include our ability to (i) increase security and commercial printing and plastic card sales and (ii) increase sales of our digital products. We have approximately $417,000 of cash available to us under a credit facility as of December 31, 2009, that we recently extended the expiration date to January 2012, we will likely need additional funds in the future in order to fund our working capital needs including equity capital. In addition, as the result of our acquisition of Premier Packaging Corp. in February 2010, we have access to a $1,000,000 revolving line of credit, although such funds can only be accessed by the Premier Packaging division. If we are not successful in generating needed funds from operations or in capital raising transactions, we may need to reduce our costs which measures could include selling or consolidating certain operations or assets, and delaying, canceling or scaling back product development and marketing programs. These measures could materially and adversely affect our ability to operate profitably.

***We have a significant amount of relatively short term indebtedness and may be unable to satisfy our obligations to pay interest and principal thereon when due.***

As of December 31, 2009, we have the following approximate amounts of outstanding indebtedness:

(i) $450,000 Convertible Note bearing interest at 8% per annum due June 23, 2012, convertible into up to 260,116 shares of Document Security Systems Common Stock, and is secured by the accounts receivable of the Company, excluding the accounts receivable of the Company's wholly owned subsidiaries, Plastic Printing Professionals and DPI Secuprint, respectively.

(ii) $350,000 Convertible Note bearing interest at 10% per annum due November 24, 2012, convertible into up to 218,750 shares of Document Security Systems Common Stock and is secured by the assets of the Company's wholly owned subsidiary DPI Secuprint.

(iii) $575,000 Promissory Note bearing interest at 10% per annum due November 24, 2012 and accrues interest at 10% and is secured by the assets of the Company's wholly owned subsidiary DPI Secuprint.

(iv) $735,000, inclusive of accrued interest of approximately $152,000, due under a Credit Facility under which the Company can borrow up to $1,000,000 bearing interest at LIBOR plus 2% per annum due January 4, 2012.

Furthermore, in February 2010, the Company entered into new debt agreements in conjunction with its acquisition of Premier Packaging Corp as follows:

(v) A $1,500,000 Term Loan which matures March 1, 2013 and is payable in 35 monthly payments of $25,000 plus interest commencing March 1, 2010 and a payment of $625,000 on the 36 month. Interest accrues at 1 Month LIBOR plus 3.75% and is secured by all of the assets of the Company's subsidiary, Premier Packaging Corporation, which the Company acquired on February 12, 2010. The Company subsequently entered into a credit swap agreement to lock into a 5.66% effective interest over the life of the term loan. The Loan has also been guaranteed by Document Security Systems, and its subsidiaries Plastic Printing Professionals and DPI Secuprint.

(vi) Up to $1,000,000 in a revolving line of credit available for use by Premier Packaging, subject to certain limitations which matures on February 12, 2011 and is payable in monthly installments of interest only beginning on March 1, 2010. Interest accrues at 1 Month LIBOR plus 3.75%. $735,000. As of March 19, 2010, approximately $300,000 is outstanding on the line. The revolving line of credit has also been guaranteed by Document Security System, and its subsidiaries Plastic Printing Professionals and DPI Secuprint.

Absent a new financing or series of financings, our current operations may not generate sufficient cash to pay the interest and principal on these obligations when they become due. Accordingly, we may default in these obligations in the future.

***Our limited cash resources may not be sufficient to fund continuing losses from operations and the expenses of the current patent validity and patent infringement litigations.***

The cost to defend current and future litigation may be significant. We cannot assure you that the ultimate cost of current known or future unknown litigation and claims will not exceed our current expectations and/or our ability to pay such costs and it is possible that such litigation costs could have a material adverse effect on our business, financial condition and operating results. In addition, litigation is time consuming and could divert management attention and resources away from our business, which could adversely affect our business, financial condition and operating results.

***If we lose our current litigation, we may lose certain of our technology rights, which may affect our business plan.***

We are subject to litigation and threatened litigation, including without limitation our litigation with the European Central Bank, in which parties allege, among other things, that certain of our patents are invalid. If the ECB or other parties are successful in invalidating any or all of our patents, it may materially affect us, our financial condition, and our ability to market and sell certain of our products based on any patent that is invalidated. Furthermore, we have granted nearly all control over our ECB Litigation to a third party, Trebuchet Capital Partners, LLC., who may or may not have the resources or capabilities to successfully defend our patent rights.

***If we are unable to adequately protect our intellectual property, our competitive advantage may disappear.***

Our success will be determined in part by our ability to obtain United States and foreign patent protection for our technology and to preserve our trade secrets. Because of the substantial length of time and expense associated with developing new document security technology, we place considerable importance on patent and trade secret protection. We intend to continue to rely primarily on a combination of patent protection, trade secrets, technical measures, copyright protection and nondisclosure agreements with our employees and customers to establish and protect the ideas, concepts and documentation of software and trade secrets developed by us. Our ability to compete and the ability of our business to grow could suffer if these intellectual property rights are not adequately protected. There can be no assurance that our patent applications will result in patents being issued or that current or additional patents will afford protection against competitors. We rely on a combination of patents, copyrights, trademarks and trade secret protection and contractual rights to establish and protect our intellectual property. Failure of our patents, copyrights, trademarks and trade secret protection, non-disclosure agreements and other measures to provide protection of our technology and our intellectual property rights could enable our competitors to more effectively compete with us and have an adverse effect on our business, financial condition and results of operations. In addition, our trade secrets and proprietary know-how may otherwise become known or be independently discovered by others. No guarantee can be given that others will not independently develop substantially equivalent proprietary information or techniques, or otherwise gain access to our proprietary technology.

In addition, we may be required to litigate in the future to enforce our intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or invalidity. Any such litigation could result in substantial costs and diversion of resources and could have a material adverse effect on our business, financial condition or results of operations, and there can be no assurances of the success of any such litigation.

***We may face intellectual property infringement or other claims against us, our customers or our intellectual property that could be costly to defend and result in our loss of significant rights.***

Although we have received patents with respect to certain technologies of ours, there can be no assurance that these patents will afford us any meaningful protection. Although we believe that our use of the technology and products we developed and other trade secrets used in our operations do not infringe upon the rights of others, our use of the technology and trade secrets we developed may infringe upon the patents or intellectual property rights of others. In the event of infringement, we could, under certain circumstances, be required to obtain a license or modify aspects of the technology and trade secrets we developed or refrain from using same. We may not have the necessary financial resources to defend an infringement claim made against us or be able to successfully terminate any infringement in a timely manner, upon acceptable terms and conditions or at all. Failure to do any of the foregoing could have a material adverse effect on us and our financial condition. Moreover, if the patents, technology or trade secrets we developed or use in our business are deemed to infringe upon the rights of others, we could, under certain circumstances, become liable for damages, which could have a material adverse effect on us and our financial condition. As we continue to market our products, we could encounter patent barriers that are not known today. A patent search will not disclose applications that are currently pending in the United States Patent Office, and there may be one or more such pending applications that would take precedence over any or all of our applications.

Furthermore, third parties may assert that our intellectual property rights are invalid, which could result in significant expenditures by us to refute such assertions. If we become involved in litigation, we could lose our proprietary rights, be subject to damages and incur substantial unexpected operating expenses. Intellectual property litigation is expensive and time-consuming, even if the claims are subsequently proven unfounded, and could divert management’s attention from our business. If there is a successful claim of infringement, we may not be able to develop non-infringing technology or enter into royalty or license agreements on acceptable terms, if at all. If we are unsuccessful in defending claims that our intellectual property rights are invalid, we may not be able to enter into royalty or license agreements on acceptable terms, if at all. This could prohibit us from providing our products and services to customers, which could have a material adverse effect on us and our financial condition.

***The value of our intangible assets may not be equal to their carrying values.***

As of December 31, 2009, we had $2.9 million of intangible assets. We are required to evaluate the carrying value of such intangibles. including goodwill. Whenever events or changes in circumstances indicate that the carrying value of an intangible asset, including goodwill, may not be recoverable, we determine whether there has been impairment by comparing the anticipated undiscounted cash flows (discounted cash flows for goodwill) from the operation and eventual disposition of the product line with its carrying value. If any of our intangible assets are deemed to be impaired then it will result in a significant reduction of the operating results in such period.

***If our products and services do not achieve market acceptance, we may not achieve our revenue and net income goals in the time prescribed or at all.***

We are at the early stage of introducing our document security technology and products to the market. If we are unable to operate our business as contemplated by our business model or if the assumptions underlying our business model prove to be unfounded, we could fail to achieve our revenue and net income goals within the time we have projected, or at all, which could have a material adverse effect on our business. As a result, the value of your investment could be significantly reduced or completely lost.

We cannot assure you that a sufficient number of such companies will demand our products or services or other document security products. In addition, we cannot predict the rate of market's acceptance of our document security solutions. Failure to maintain a significant customer base may have a material adverse effect on our business.

***Certain of our recently developed products are not yet commercially accepted and there can be no assurance that those products will be accepted, which would adversely affect our financial results.***

Over the past several years, we have spent significant funds and time to create new products by applying our technologies onto media other than paper, including plastic and cardboard packaging, and delivered our technologies digitally. We have had limited success in selling our products that are on cardboard packaging and those that are delivered digitally. Our business plan for 2010 and beyond includes plans to incur significant marketing and sales costs for these newer products, particularly the digitally delivered products. If we are not able to sell these new products, our financial results will be adversely affected.

***The results of our research and development efforts are uncertain and there can be no assurance of the commercial success of our products.***

We believe that we will need to continue to incur research and development expenditures to remain competitive. The products we currently are developing or may develop in the future may not be technologically successful. In addition, the length of our product development cycle may be greater than we originally expect and we may experience delays in future product development. If our resulting products are not technologically successful, they may not achieve market acceptance or compete effectively with our competitors' products.

***Changes in document security technology and standards could render our applications and services obsolete.***

The market for document security products, applications, and services is fast moving and evolving. Identification and authentication technology is constantly changing as we and our competitors introduce new products, applications, and services, and retire old ones as customer requirements quickly develop and change. In addition, the standards for document security are continuing to evolve. If any segments of our market adopt technologies or standards that are inconsistent with our applications and technology, sales to those market segments could decline, which could have a material adverse effect on us and our financial condition.

***The market in which we operate is highly competitive, and we may not be able to compete effectively, especially against established industry competitors with greater market presence and financial resources.***

Our market is highly competitive and characterized by rapid technological change and product innovations. Our competitors may have advantages over us because of their longer operating histories, more established products, greater name recognition, larger customer bases, and greater financial, technical and marketing resources. As a result, they may be able to adapt more quickly to new or emerging technologies and changes in customer requirements, and devote greater resources to the promotion and sale of their products. Competition may also force us to decrease the price of our products and services. We cannot assure you that we will be successful in developing and introducing new technology on a timely basis, new products with enhanced features, or that these products, if introduced, will enable us to establish selling prices and gross margins at profitable levels.

***Our growth strategy depends, in part, on our acquiring complementary businesses and assets and expanding our existing operations to include manufacturing capabilities, which we may be unable to do.***

Our growth strategy is based, in part, on our ability to acquire businesses and assets that are complementary to our existing operations and expanding our operations to include manufacturing capabilities. We may also seek to acquire other businesses. The success of this acquisition strategy will depend, in part, on our ability to accomplish the following:

- identify suitable businesses or assets to buy;
- complete the purchase of those businesses on terms acceptable to us;
- complete the acquisition in the time frame we expect; and
- improve the results of operations of the businesses that we buy and successfully integrate their operations into our own.

Although we were able to acquire our Plastic Printing Professionals, Inc. subsidiary in February 2006 and our DPI Secuprint subsidiary in December 2008, and Premier Packaging in February 2010, there can be no assurance that we will be successful in pursuing any or all of these steps on future transactions. Our failure to implement our acquisition strategy could have an adverse effect on other aspects of our business strategy and our business in general. We may not be able to find appropriate acquisition candidates, acquire those candidates that we find or integrate acquired businesses effectively or profitably.

Our acquisition program and strategy may lead us to contemplate acquisitions of companies in bankruptcy, which entail additional risks and uncertainties. Such risks and uncertainties include, without limitation, that, before assets may be acquired, customers may leave in search of more stable providers and vendors may terminate key relationships. Also, assets are generally acquired on an “as is” basis, with no recourse to the seller if the assets are not as valuable as may be represented. Finally, while bankrupt companies may be acquired for comparatively little money, the cost of continuing the operations may significantly exceed expectations.

We have in the past used, and may continue to use, our Common Stock as payment for all or a portion of the purchase price for acquisitions. If we issue significant amounts of our Common Stock for such acquisitions, this could result in substantial dilution of the equity interests of our stockholders.

***We may not realize the anticipated benefits of our recent acquisitions.***

Our expectations regarding the earnings, operating cash flow, capital expenditures and liabilities resulting from our recent acquisition Premier Packaging Corp in February 2010 are based on information currently available to us and may prove to be incorrect. In addition, we may not realize any anticipated benefits of either of this acquisition and may not be successful in integrating the acquired assets into our existing business.

***If we fail to retain our key personnel and attract and retain additional qualified personnel, we might not be able to pursue our growth strategy.***

Our future success depends upon the continued service of our executive officers and other key sales and research personnel who possess longstanding industry relationships and technical knowledge of our products and operations. The loss of any of our key employees could negatively impact our ability to pursue our growth strategy and conduct operations. Although we believe that our relationship with these individuals is positive, there can be no assurance that the services of these individuals will continue to be available to us in the future. There can be no assurance that these persons will continue to agree to be employed by us after such dates.

***If we do not successfully expand our sales force, we may be unable to increase our revenues.***

We must expand the size of our marketing activities and sales force to increase revenues. We continue to evaluate various methods of expanding our marketing activities, including the use of outside marketing consultants and representatives and expanding our in-house marketing capabilities. If we are unable to hire or retain qualified sales personnel, if newly hired personnel fail to develop the necessary skills to be productive, or if they reach productivity more slowly than anticipated, our ability to increase our revenues and grow could be compromised. The challenge of attracting, training and retaining qualified candidates may make it difficult to meet our sales growth targets. Further, we may not generate sufficient sales to offset the increased expense resulting from expanding our sales force or we may be unable to manage a larger sales force.

***Future growth in our business could make it difficult to manage our resources.***

Our anticipated business expansion could place a significant strain on our management, administrative and financial resources. Significant growth in our business may require us to implement additional operating, product development and financial controls, improve coordination among marketing, product development and finance functions, increase capital expenditures and hire additional personnel. There can be no assurance that we will be able to successfully manage any substantial expansion of our business, including attracting and retaining qualified personnel. Any failure to properly manage our future growth could negatively impact our business and operating results.

***We cannot predict our future capital needs and we may not be able to secure additional financing.***

We may need to raise additional funds in the future to fund our working capital needs, to fund more aggressive expansion of our business, to complete development, testing and marketing of our products, or to make strategic acquisitions or investments. We may require additional equity or debt financings, collaborative arrangements with corporate partners or funds from other sources for these purposes. No assurance can be given that necessary funds will be available for us to finance our development on acceptable terms, if at all. Furthermore, such additional financings may involve substantial dilution of our stockholders or may require that we relinquish rights to certain of our technologies or products. In addition, we may experience operational difficulties and delays due to working capital restrictions. If adequate funds are not available from operations or additional sources of financing, we may have to delay or scale back our growth plans.

**Risks Related to Our Stock**

***Provisions of our certificate of incorporation and agreements could delay or prevent a change in control of our company.***

Certain provisions of our certificate of incorporation may discourage, delay, or prevent a merger or acquisition that a stockholder may consider favorable. These provisions include:

- the authority of the Board of Directors to issue preferred stock; and
- a prohibition on cumulative voting in the election of directors.

***We have a large number of authorized but unissued shares of common stock, which our management may issue without further stockholder approval, thereby causing dilution of your holdings of our common stock.***

As of December 31, 2009, there were approximately 184 millionauthorized but unissued shares of our common stock. Our management continues to have broad discretion to issue shares of our common stock in a range of transactions, including capital-raising transactions, mergers, acquisitions, for anti-takeover purposes, and in other transactions, without obtaining stockholder approval, unless stockholder approval is required for a particular transaction under the rules of the NYSE Amex, New York law, or other applicable laws. If our Board of Directors determines to issue additional shares of our common stock from the large pool of authorized but unissued shares for any purpose in the future without obtaining stockholder approval, your ownership position would be diluted without your further ability to vote on such transaction.

***The exercise of our outstanding options and warrants and vesting of restricted stock awards may depress our stock price.***

As of December 31, 2009, we had (i) outstanding stock options and warrants to purchase an aggregate of 2,089,020 shares of our Common Stock at exercise prices ranging from $1.60 to $12.65 per share; (ii). 85,000 restricted shares of our common stock that are subject to various vesting terms, and (iii) convertible notes that convert to up to 478,866 shares of our common stock. To the extent that these securities are converted into common stock, dilution to our stockholders will occur, Moreover, the terms upon which we will be able to obtain additional equity capital may be adversely affected, since the holders of these securities can be expected to exercise or convert them at a time when we would, in all likelihood, be able to obtain any needed capital on terms more favorable to us than the exercise and conversion terms provided by those securities.

Sales of these shares in the public market, or the perception that future sales of these shares could occur, could have the effect of lowering the market price of our common stock below current levels and make it more difficult for us and our stockholders to sell our equity securities in the future.

Sale or the availability for sale of shares of common stock by stockholders could cause the market price of our common stock to decline and could impair our ability to raise capital through an offering of additional equity securities.

***We do not intend to pay cash dividends.***

We do not intend to declare or pay cash dividends on our common stock in the foreseeable future. We anticipate that we will retain any earnings and other cash resources for investment in our business. The payment of dividends on our common stock is subject to the discretion of our Board of Directors and will depend on our operations, financial position, financial requirements, general business conditions, restrictions imposed by financing arrangements, if any, legal restrictions on the payment of dividends and other factors that our Board of Directors deems relevant.

***We may not meet the continued listing standards of the NYSE AMEX***

We received notice from the NYSE Amex (formerly NYSE Alternext US) on December 2, 2008 that based on a review of our Form 10-Q for the period ended September 30, 2008, that we did not meet certain of the Exchange’s continued listing standards related to stockholders’ equity as set forth in Part 10 of the NYSE Amex Company Guide. We were afforded the opportunity to submit a plan of compliance to the Exchange and on January 9, 2009 presented our plan to the Exchange. On January 29, 2009, the Exchange notified us that it accepted our plan of compliance and granted to us an extension until June 2, 2010 to regain compliance with the continued listing standards and that our listing is being continued pursuant to this extension. We are subject to periodic review by Exchange Staff during the extension period. Failure to make progress consistent with the plan or to regain compliance with the continued listing standards by the end of the extension period could result in the Company being delisted from the Exchange. There is no guarantee that we will be able to regain compliance to the listing standards and therefore, our common shares may no longer be able to be traded, which could cause the market price of our common stock to decline and could impair our ability to raise capital through an offering of additional equity securities.

**ITEM 2 - PROPERTIES**

Our administrative offices are approximately 4,700 square feet and are located in the First Federal Plaza Building, 28 East Main Street, Rochester, New York 14614 which we occupy under a lease that will expire in 2011. Our plastic printing division leases approximately 25,000 square feet in Brisbane, CA in a lease that will expire in July 2014. DPI Secuprint, our commercial printing group leases an approximately 20,000 square foot facility in Rochester, NY under a lease expiring in 2013. On February 12, 2010, in conjunction with the acquisition of Premier Packaging, the Company entered into a lease for approximately 40,000 square feet of production and warehouse space located in Victor, NY, a suburb of Rochester. The lease is with Bzdick Properties, LLC, an entity owned by the former owner of Premier Packaging and the Company’s new President and COO, and will expire on February 12, 2020. We believe that our facilities are adequate for our current operations. The Company also believes that it can negotiate renewals or similar lease arrangements on acceptable terms when our current leases expire.

**ITEM 3 - LEGAL PROCEEDINGS**

On August 1, 2005, the Company commenced a suit against the European Central Bank ("ECB") alleging patent infringement by the ECB and claimed unspecified damages. We brought the suit in the European Court of First Instance in Luxembourg. We alleged that all Euro banknotes in circulation infringe the Company European Patent 0 455 750B1 (the "Patent"), which covers a method of incorporating an anti-counterfeiting feature into banknotes or similar security documents to protect against forgeries by digital scanning and copying devices. The Court of First Instance ruled on September 5, 2007 that it does not have jurisdiction to rule on the patent infringement claim, and also ruled that we will be required to pay attorneys and court fees of the ECB. The ECB formally requested the Company to pay attorneys and court fees in the amount of Euro 93,752 which, unless the amount is settled will be subject to an assessment procedure that will not likely be concluded until late 2010, which the Company will accrue as soon as the assessed amount, if any, is reasonably estimatable.

On March 24, 2006, the Company received notice that the ECB had filed a separate claim in the United Kingdom and Luxembourg courts seeking the invalidation of the Patent. Proceedings were commenced before the national courts seeking revocation and declarations of invalidity of the Patent in each of the Netherlands, Belgium, Italy, France, Spain, Germany and Austria. On March 26, 2007, the High Court of Justice, Chancery Division, Patents Court in London, England (the "English Court") ruled that the Patent was deemed invalid in the United Kingdom, and on March 19, 2008 this decision was upheld on appeal. The English Court rejected the ECB's allegations of invalidity based on lack of novelty, lack of inventive step and insufficiency, but held that the patent was invalid for added subject matter. The English Court's decision does not affect the validity of the Patent in other European countries. As a result of these decisions, the Company was notified of the final assessment of the reimbursable ECB costs for both court cases was ₤356,490, of which the Company has paid ₤332,000 through December 31, 2009 and owes approximately ₤25,000 (approximately $40,000 as of December 31, 2009), which amount was included in accrued expenses as of December 31, 2009.

On March 27, 2007 the Bundespatentgericht of the Federal Republic of Germany ruled that the German part of the Patent was valid, having considered the English Court's decision. As a result of this ruling, the Company expects to be awarded reimbursements for its costs associated with the German validity case, which is Euro 44,692 ($65,000 at December 31, 2009), which the Company will record when the amount, if any, is received. The ECB has filed an appeal against that decision, which is not expected to be decided before July 2010. On January 9, 2008 the French Court held that the Patent was invalid in France for the same reasons given by the English Court. The Company is required to pay de minimus attorneys' fees of the ECB as a result of the French decision. The Company filed an appeal against the French decision on May 7, 2008. The French appeal was heard on December 7, 2009. On March 20, 2010, the Company was informed that the decision was upheld in the French appeal. On March 12, 2008 the Dutch Court, having considered the English, German and French decisions, ruled that the Patent is valid in the Netherlands. The ECB filed an appeal against the Dutch decision on March 27, 2008. The Dutch appeal will be heard in the Hague on June 2010. On November 3, 2009, the Belgium Court held that the Patent was invalid in Belgium for the same reasons given by the English and French courts as were similarly informed by the Austrian court on November 17, 2009. Costs reimbursements, if any, associated with the Belgium and Austrian validity case are covered under the Trebuchet Agreement as described below. A trial was also held in Madrid, Spain on June 3 and 5, 2008 and oral and written closing submissions were made on July 19, 2008. On March 24, 2010 the Spanish Court ruled that the Patent was valid. In Italy the validity case is to be heard again by a newly appointed judge during 2010 and a hearing in Luxembourg is expected in 2010.

On August 20, 2008, the Company entered into an agreement with Trebuchet Capital Partners, LLC ("Trebuchet") under which Trebuchet has agreed to pay substantially all of the litigation costs associated with pending validity proceedings initiated by the European Central Bank ("ECB") in eight European countries relating to the Company's European Patent 0 455 750B1 that the Company has claimed the ECB infringed in printing of the Euro currency (the "Patent"). Trebuchet also agreed to pay substantially all of the litigation costs associated with future validity challenges filed by the ECB or other parties, provided that Trebuchet elects to assume the defense of any such challenges, in its sole discretion, and patent infringement suits filed against the ECB and certain other alleged infringers of the Patent, all of which suits may be brought at the sole discretion of Trebuchet and may be in the name of the Company, Trebuchet or both. The Company provided Trebuchet with the sole and exclusive right to manage infringement litigation relating to the Patent in Europe, including the right to initiate litigation in the name of the Company, Trebuchet or both and to choose whom and where to sue, subject to certain limitations set forth in the agreement under the terms of the Agreement, and in consideration for Trebuchet's funding obligations, the Company assigned and transferred a 49% interest of the Company's rights, title and interest in the Patent to Trebuchet which allows Trebuchet to have a separate and distinct interest in and share of the Patent, along with the right to sue and recover in litigation, settlement or otherwise to collect royalties or other payments under or on account of the Patent. In addition, the Company and Trebuchet have agreed to equally share all proceeds generated from litigation relating to the Patent, including judgments and licenses or other arrangements entered into in settlement of any such litigation. Trebuchet is also entitled to recoup any litigation expenses specifically awarded to the Company in such actions.

The Patent has thus been confirmed to be valid and enforceable in three jurisdictions (Germany, the Netherlands and Spain) that use the Euro as its national currency allowing the Company or Trebuchet Capital Partners, on the Company's behalf, to proceed with infringement cases in these countries if we choose to do so. On February 18, 2010, Trebuchet, on behalf of Document Security Systems, filed an infringement suit in the Netherlands. The suit is being lodged against the ECB and two security printing entities

with manufacturing operations in the Netherlands, Joh. Enschede Banknotes B.V.; and Koninklijke Joh. Enschede B.V. The ECB's and the security printers have been notified and the court hearing date is tentatively scheduled for January 21, 2011.

On January 31, 2003, the Company commenced an action, unrelated to the above ECB litigation, entitled New Sky Communications, Inc., As Successor-In-Interest To Thomas M. Wicker, Thomas M.Wicker Enterprises, Inc. and Document Security Consultants V. Adler Technologies, Inc. N/K/A Adlertech International, Inc. and Andrew McTaggert (United States District Court, Western District Of New York Case No.03-Cv-6044t(F)) regarding certain intellectual property in which the Company has an interest. On December 7, 2009, the Company reached an agreement to terminate all litigation in association with this suit. In conjunction with that agreement, the Company issued to the opposing parties an aggregate of 40,000 shares of common stock valued at approximately $85,000 and 50,000 of common stock warrants for the purchase of common shares at $3.00 per share valued at approximately $30,000 utilizing the Black Scholes pricing model. The Company recorded an expense related to the estimated grant date fair value of the shares and warrants issued of approximately $115,000. In addition, both parties agreed not to compete with certain of the other party's customers for 7 years. The Company does not believe that the competition agreement will have a material impact on its business.

In addition to the foregoing, we are subject to other legal proceedings that have arisen in the ordinary course of business and have not been finally adjudicated. Although there can be no assurance in this regard, in the opinion of management, none of the legal proceedings to which we are a party, whether discussed herein or otherwise, will have a material adverse effect on our results of operations, cash flows or our financial condition.

**ITEM 4 - SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

There were no matters submitted to a vote of security holders in the fourth quarter of 2009.

**ITEM 5 - MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

Our Common Stock is listed on the NYSE Amex, where it trades under the symbol "DMC."

The following table sets forth the high and low closing prices for the shares of our Common Stock, for the periods indicated.

| QUARTER ENDING | HIGH | LOW |
|---|---|---|
| March 31, 2009 | $ 1.92 | $ 1.59 |
| June 30, 2009 | 2.24 | 1.63 |
| September 30, 2009 | 2.45 | 1.86 |
| December 31, 2009 | 3.14 | 1.95 |

| QUARTER ENDING | HIGH | LOW |
|---|---|---|
| March 31, 2008 | $ 6.85 | $ 4.20 |
| June 30, 2008 | 6.87 | 4.68 |
| September 30, 2008 | 5.25 | 4.83 |
| December 31, 2008 | 4.40 | 1.40 |

From January 1, 2010 through March 19, 2010, our Common Stock had a high closing price of $4.41 and a low closing price of $2.44 and a closing price on March 19, 2010 of $4.15.

**Issued and Outstanding**

Our certificate of incorporation authorizes 200,000,000 shares of Common Stock, par value $0.02. As of March 19, 2010, we had 17,760,324 shares of Common Stock, issued and outstanding.

**Recent Issuances of Unregistered Securities**

On February 12, 2010, the Company acquired all of the outstanding common stock of Premier Packaging Corporation from Robert B. and Joan T. Bzdick for $2,000,000 in cash and 735,437 shares of the Company's common stock. The shares of common stock have not been registered under the Securities Act of 1933, as amended (the "Securities Act"), and were issued and sold in reliance upon the exemption from registration contained in Section 4(2) of the Securities Act and Rule 506 of Regulation D promulgated thereunder.

On February 17, 2010, the Company completed the sale of 20 investment units in a private placement pursuant to subscription agreements with six accredited investors. Each investment unit was comprised of 5,000 shares of the Company's common stock and five year warrants to purchase 1,000 shares of common stock at an exercise price of $3.50 per share. In the transaction, the Company sold 20 investment units for $15,000 per unit for gross cash proceeds of $300,000, consisting of 100,000 shares of common stock and warrants to purchase an aggregate of 20,000 shares of common stock. In connection with these sales EKN Financial Services Inc., a registered broker-dealer, acted as non-exclusive placement agent. EKN Financial Services, Inc. received a cash fee in the aggregate of $30,000 as commission for these sales. On February 17, 2010, the Company also sold 20 investment units for gross cash proceeds of $270,000, consisting of 100,000 shares of common stock and warrants to purchase an aggregate of 20,000 shares of common stock. No placement agent fees were paid on these sales. The shares of common stock have not been registered under the Securities Act of 1933, as amended (the "Securities Act"), and were issued and sold in reliance upon the exemption from registration contained in Section 4(2) of the Securities Act and Rule 506 of Regulation D promulgated thereunder.

On January 21, 2010, the Company issued 29,400 shares to its former investor relations firm for payment of services. On February 23, 2010, the Company issued 304,000 common stock pursuant to the exercise of warrants in which the Company received proceeds of $608,000. The shares of common stock have not been registered under the Securities Act of 1933, as amended (the "Securities Act"), and were issued and sold in reliance upon the exemption from registration contained in Section 4(2) of the Securities Act and Rule 506 of Regulation D promulgated thereunder.

**Stockholders**

As of March 19, 2010, we had approximately 902 record holders of our Common Stock. This number does not include the number of persons whose shares are in nominee or in “street name” accounts through brokers.

**Dividends**

We did not pay dividends during 2009 or 2008. We presently intend to retain our cash for use in the operation and expansion of our business and, therefore, do not anticipate paying any cash dividends in the foreseeable future.

**Stock Transfer Agent and Warrant Agent**

Our stock transfer agent is American Stock Transfer & Trust Co., 6201 15th Avenue, Brooklyn, NY 11219. We act as our own warrant agent for our outstanding warrants.

**Share Repurchased by the Registrant**

We did not purchase or repurchase any of our securities in the fiscal year ended December 31, 2009, including the fourth quarter.

The information required by Item 201(d) of Regulation S-K will be contained in our Proxy Statement for our Annual Stockholders Meeting, which we will file with the Securities and Exchange Commission within 120 days after December 31, 2009, and which is incorporated by reference herein.

## ITEM 7 - MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

**Forward-Looking Statements**

This Annual Report 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, including statements that contain the words “believes,” “anticipates,” “expects,” “plans,” “intends” and similar words and phrases. These forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from the results projected in any forward-looking statement. In addition to the factors specifically noted in the forward-looking statements, other important factors, risks and uncertainties that could result in those differences include, but are not limited to, those discussed under Part I, Item 1A “Risk Factors” in this Annual Report. The forward-looking statements are made as of the date of this Annual Report, and we assume no obligation to update the forward-looking statements, or to update the reasons why actual results could differ from those projected in the forward-looking statements. Investors should consult all of the information set forth in this report and the other information set forth from time to time in our reports filed with the Securities and Exchange Commission pursuant to the Securities Exchange Act of 1934, including our reports on Forms 10-Q and 8-K.

The following discussion should be read in conjunction with the Consolidated Financial Statements and Notes thereto included in Item 8 of this Annual Report.

**Overview**

Document Security Systems, Inc., markets and sells products designed to protect valuable information from unauthorized scanning, copying, and digital imaging. We have developed security technologies that are applied during the normal printing process and by all printing methods including traditional offset, gravure, flexo, digital or via the internet on paper, plastic, or packaging. As of March 22, 2010, we hold 14 patents that protect our technology and have approximately 57 patent applications in process. Our technologies and products are used by federal, state and local governments, law enforcement agencies and are also applied to a broad variety of industries as well, including financial institutions, high technology and consumer goods, entertainment and gaming, healthcare/pharmaceutical, defense and genuine parts industries. Our customers use our technologies where there is a need for enhanced security for protecting and verification of critical financial instruments and vital records, or where there are concerns of counterfeiting, fraud, identity theft, brand protection and liability.

We have developed or acquired over 30 technologies that provide to our customers a wide spectrum of solutions. We sell our products under the AuthentiGuard® name generally in the following ways: (a) as generic products, including safety paper and plastic cards geared for the end user market for printed security products; (b) as custom printed products; (c) as technology licenses; or (d) as customized digital implementations.

In 2006, we acquired San Francisco-based Plastic Printing Professionals, Inc. ("P3"), a privately held security printer specializing in plastic cards containing state of the art multiple or singular security technologies. P3's primary focus is manufacturing long-life composite, laminated and surface printed cards which can include magnetic stripes, bar codes, holograms, signature panels, invisible ink, micro fine printing, guilloche patterns, Biometric, RFID and a patent-pending watermark technology. P3's products are marketed through an extensive broker network that covers much of North America, Europe and South America. P3's product and client list includes the Grammy Awards, the Country Music Association awards, sporting event media cards, ID cards for major airports and Latin American and African driver's licenses. Our acquisition of P3 marked the initial execution of our strategy to expand our manufacturing capabilities through acquisitions in order to expand our custom security printing business. During 2007, we moved P3's operation to a 25,000 square foot facility and upgraded some of its equipment, most notably with a significant investment in a new state of the art laminator. These actions were taken in order to significantly increase the capacity and efficiency of the operation to meet expected future demand requirements. During 2008, we placed approximately $600,000 of leased equipment into service at our plastic printing division to significantly increase the production capability and expand its services in the variable data card and RFID markets. These leases were accounted for as operating leases.

On August 20, 2008, we entered into an agreement with Trebuchet Capital Partners, LLC in which Trebuchet agreed to pay substantially all of the litigation costs associated with pending litigation proceedings initiated by the European Central Bank in eight European countries relating to the Company's European Patent 0 455 750B1 that the Company has claimed the ECB infringed in printing of the Euros currency in exchange for a 50% share of any proceeds generated from the litigation. Under the terms of the agreement, and in consideration for Trebuchet's funding obligations, the Company assigned and transferred a 49% interest of the Company's rights, title and interest in the Patent to Trebuchet which allows Trebuchet to have as a separate and exclusive interest including a separate and distinct right to exploit the Patent.

In December 2008, we acquired substantially all of the assets of DPI of Rochester, LLC, a million privately held commercial printer with approximately $7.6 million in sales in 2007 located in Rochester, NY. We formed a new subsidiary called DPI Secuprint to house this new company. As a result of this acquisition, we have significantly improved our ability to meet our current and expected future demand of our security paper products as well as improving our competitiveness in the market for custom security printing, especially in the areas of vital records, coupons, transcripts, and prescription paper. In addition, as a result of the acquisition, we believe we can offer our customers a wider range of commercial printing offerings.

In the past few years, we have divested two operations so that we could focus our efforts on security and commercial printing. During 2007, we sold the assets of our retail printing and copying division, called Patrick Printing. In October 2009, we sold the assets and liabilities associated with our Legalstore.Com business in exchange for common stock of Internet Media Services, Inc., representing approximately 37% of the outstanding shares of the newly formed company.

On February 12, 2010, the Company acquired all of the outstanding common stock of Premier Packaging Corporation from Robert B. and Joan T. Bzdick for $2,000,000 in cash and 735,437 shares of the Company's common stock. In conjunction with the transaction, the Company entered into a Credit Facility Agreement with RBS Citizens, N.A. ("Citizens Bank") pursuant to which Citizens Bank provided Premier Packaging Corporation with a term loan of $1,500,000, and a revolving line of $1,000,000. The Credit Facility Agreement contains customary representations and warranties, affirmative and negative covenants, and events of default and is secured by all of the assets of Premier Packaging Corporation. The credit facilities are also secured by cross guarantees by Document Security Systems, Inc., and its other wholly owned subsidiaries, Plastic Printing Professionals, Inc. and Secuprint, Inc. The $1,500,000 term loan matures March 1, 2013 and is payable in 35 monthly payments of $25,000 plus interest commencing March 1, 2010 and a payment of $625,000 on the 36 month. Interest accrues at 1 Month LIBOR plus 3.75%. The proceeds of the term loan were used as partial payment of the purchase of all of the outstanding common stock of Premier Packaging Corporation. The $1,000,000 revolving line of credit matures on February 12, 2011 and is payable in monthly installments of interest only beginning on March 1, 2010. Interest accrues at 1 Month LIBOR plus 3.75%. The Company subsequently entered into a credit swap agreement to lock into a 5.66% effective interest over the life of the term loan.

## RESULTS OF OPERATIONS FOR THE FISCAL YEARS ENDED DECEMBER 31, 2009 AND 2008

The following discussion and analysis provides information that our management believes is relevant to an assessment and understanding of our results of operations and financial condition. In December 2008, we acquired substantially all of the assets of DPI of Rochester, LLC, a $7.6 million privately held commercial printer located in Rochester, NY with approximately $7.6 million in sales in 2007. We formed a new subsidiary called DPI Secuprint to house this new company. DPI Secuprint's results for the period from December 19, 2008 to December 31, 2008 are included in 2008 amounts. In October 2009, the Company sold its Legalstore.com division. In accordance with ASC 205-20-45, the Company reported the results of Legalstore.com as continued operations because the operations and cash flows of the component have not been eliminated and given the Company's continued involvement after the sale. The discussion should be read in conjunction with the financial statements and footnotes that appear elsewhere in this report.

### Revenue

| | Year Ended December 31, 2009 | Year Ended December 31, 2008 | % change |
|---|---|---|---|
| *Revenue* | | | |
| Security and commercial printing | $ 8,773,000 | $ 4,386,000 | 100% |
| Technology license royalties and digital solutions | 783,000 | 1,647,000 | -52% |
| Legal products | 355,000 | 610,000 | -42% |
| *Total Revenue* | 9,911,000 | 6,643,000 | 49% |

***Revenue - 2009 vs 2008***: Revenue in 2009 increased 49% from 2008. Security and commercial print sales increased 100% which reflects the impact of the Company's acquisition of DPI Secuprint, a commercial printer, in December, 2008. This increase was offset by a decrease in royalty revenue of 52% which primarily reflects the impact of a non-recurring royalty of $542,000 recorded in the second quarter of 2008. Furthermore, the Company experienced a 42% decline of revenue at its Legalstore.com division due to the sale of the division in October of 2009, as well as a decline in revenue prior to the sale caused by the global recession. In accordance with ASC 205-20-45, the Company reported the results of Legalstore.com as continued operations because the operations and cash flows of the component have not been eliminated and given the Company's continued involvement after the sale.

During 2009, all of the Company's divisions were adversely affected by significant delays or reductions in orders by core customers that reflected the rapid decline in the U.S. and global economies during the latter half of 2008 and the first half of 2009. The Company began to see demand in each of divisions to return to more traditional levels in the third quarter of 2009 and expects this trend to continue as the U.S. and global economies stabilize.

**Gross profit**

| | Year Ended December 31, 2009 | Year Ended December 31, 2008 | % change |
|---|---|---|---|
| *Costs of revenue* | | | |
| Security and commercial printing | $ 6,063,000 | $ 2,663,000 | 128% |
| Technology license royalties and digital solutions | 14,000 | 14,000 | 0% |
| Legal products | 179,000 | 352,000 | -49% |
| *Total cost of revenue* | 6,256,000 | 3,029,000 | 107% |
| | | | |
| *Gross profit* | | | |
| Security and commercial printing | 2,710,000 | 1,723,000 | 57% |
| Technology license royalties and digital solutions | 769,000 | 1,633,000 | -53% |
| Legal products | 176,000 | 258,000 | -32% |
| *Total gross profit* | 3,655,000 | 3,614,000 | 1% |

| | Year Ended December 31, 2009 | Year Ended December 31, 2008 | % change |
|---|---|---|---|
| Gross profit percentage: | 37% | 54% | -32% |

Gross Profit - *2009 vs 2008*

Gross profit in 2009 was flat as compared to 2008. While sales increased in 2009, the mix of sales was significantly different from 2008 due to the increase of commercial printing by the Company as a result of the Company's acquisition of DPI Secuprint in December 2008. Commercial printing typically carries lower margins than the Company's security printing projects. In addition, the Company increased the fixed cost component of its cost of sales as a result of investments in equipment at the Company's plastic printing facility which while significantly increasing that division's production capacity and capabilities, caused margins in that division to decline as sales gains did not fully offset the increase in costs. Finally, gross margins were favorably impacted by a one-time non-recurring deferred revenue item in 2008 that carried a 100% gross margin. Without this one-time item, 2009 gross margins would have increased 18% over 2008.

**Operating Expenses**

| | Year Ended December 31, 2009 | Year Ended December 31, 2008 | % change |
|---|---|---|---|
| *Operating Expenses* | | | |
| Sales, general and administrative compensation | $ 3,638,000 | $ 2,966,000 | 23% |
| Professional Fees | 539,000 | 896,000 | -40% |
| Sales and marketing | 154,000 | 340,000 | -55% |
| Research and development | 292,000 | 432,000 | -32% |
| Rent and utilities | 477,000 | 509,000 | -6% |
| Other | 710,000 | 807,000 | -12% |
| | $ 5,810,000 | $ 5,950,000 | -2% |
| | | | |
| *Other Operating Expenses* | | | |
| Depreciation and amortization | 148,000 | 167,000 | -11% |
| Stock based payments | 68,000 | 1,747,000 | -96% |
| Impairment of patent defense costs and other intangible assets | - | 797,000 | |
| Amortization of intangibles | 1,342,000 | 1,972,000 | -32% |
| | 1,558,000 | 4,683,000 | -67% |
| | | | |
| *Total Operating Expenses* | 7,368,000 | 10,633,000 | -31% |

*Selling, General and Administrative – 2009 vs 2008*

Sales, general and administrative compensation costs were 23% higher in 2009, compared to 2008, due to sales and administrative staff additions as the result of the Company's acquisition of its commercial printing business in December 2008. Otherwise, SG&A compensation costs at the Company's remaining divisions would have decreased 52% during 2009 compared to 2008, as the result of significant staff reductions in sales, marketing and administration that the Company initiated in the middle of 2008 and during the first quarter of 2009.

Professional fees decreased 40% in 2009 from 2008 primarily as a result of a significant decrease in consulting fees which was offset by a significant increase in legal fees incurred by the Company as a result of increase of usage of external legal counsel after the Company's legal counsel left the Company in March of 2009, including an increase in legal costs associated with non-ECB related litigation matters. The Company has evaluated its use of external legal counsel and expects legal costs to decline in 2010.

Sales and marketing expenses decreased significantly in 2009 as compared to 2008 as the Company changed its primary sales and marketing strategy resulting in a reduction in its non-direct marketing costs, its international sales cost, and an overall reduction in sales related travel. The Company focused its efforts in 2009 on direct sales techniques that utilize telephone and web-conferencing communication with current and prospective customers, along with increasing its internet presence focused on the Company's primary e-commerce website www.protectedpaper.com.

Research and development costs consist primarily of compensation costs for research personnel and direct costs for the use of third-party printers' facilities to test our technologies on equipment that we do not have access to internally. Research and development costs decreased during 2009 compared to 2008 as the result of lower external research costs and reduction in compensation cost as the Company reduced the department by two persons.

Rent and utilities increased in 2009 as a result of the Company's acquisition of its commercial printing business in December 2008, which operates a 20,000 square foot facility in Rochester, NY. These increases were offset by a reduction in utility costs at the Company's plastic printing facility, along with rental cost offsets from a sublease for approximately 7,500 feet at the Company's plastic printing facility.

Other operating expenses are primarily equipment maintenance and repairs, office supplies, IT support, bad debt expense and insurance costs. On a consolidated basis, these costs decreased by 12% in 2009 as compared to 2008, despite the addition of other expenses associated with the Company's acquisition of DPI Secuprint in December 2008, as the Company reduced insurance costs and office and miscellaneous costs

Stock-based compensation includes expense charges for all stock-based awards to employees, directors and consultants. Such awards include option grants, warrant grants, and restricted stock awards. Stock-based compensation 2009 as compared to 2008, as current-period stock based compensation expense was offset by reversals of previously recorded stock-based compensation expense for stock options and restricted shares issued to the Company's employees which terminated unvested due to employee terminations that occurred during 2009. Furthermore, the Company's compensation costs for option awards granted in 2009 are lower than past awards as the Company has typically granted out-the-money options due to the Company's lower than average stock price during the year.

Impairment of patent defense costs and other intangible assets: On March 19, 2008, the Company received notification that its appeal of the invalidation of its European Patent 455750B1 in the UK was not successful. As result of the adverse court decision, the Company recognized an impairment loss of $292,000 associated with costs directly related to the U.K appeal as of March 31, 2008. The impairment loss includes a judgment for reimbursement of estimated counterpart legal fees. In January, 2009, the Company received a formal request for fee reimbursement from the ECB for a total of $420,000 inclusive of amounts already paid by the Company. The Company hired an independent firm to assist the Company in reducing or eliminating the ECB's fees request, however, the Company recorded $145,000 as additional accrued expenses as of December 31, 2008. On July 31, 2009, the UK Court made the final assessment of costs for the UK patent validity case due from the Company to the ECB of ₤356,490 of which the Company has paid ₤332,000 through December 31, 2009 and owes approximately ₤25,000 ($40,000 as of December 31, 2009) as of December 31, 2009, which amount was included in accrued expenses as of December 31, 2009. In addition, the Company recorded an impairment of $361,000 for a license agreement the Company had acquired in 2006 for RSS Barcodes for which the Company assessed that the probable future cash flows derived from the license did not support the net carrying value of the license as of December 31, 2008.

No such expense was incurred in 2009.

Amortization of intangibles expense decreased 32% in 2009, as compared to 2008 as a result of the reduction in the Company's net capitalized patent acquisition and defense costs asset since the Company transferred and assigned 49% of its interest in the patent to a third-party in August 2008, which resulted in a reduction in the asset of approximately $1.7 million. As a result, the Company's amortizable base reduced significantly.

**Other Income and expenses**

| | Year Ended December 31, 2009 | Year Ended December 31, 2008 | % change |
|---|---|---|---|
| **Other income (expense):** | | | |
| Gain/(Loss) on foreign currency adjustments | 15,000 | (59,000) | -125% |
| Interest Income | 18,000 | - | |
| Interest expense | (259,000) | (136,000) | 90% |
| Amortizaton of note discount | (250,000) | (8,000) | 3025% |
| Loss on sale of patent assets | - | (1,170,000) | |
| Gain on deconsolidation of Legalstore.com division | 26,000 | - | |
| Litigation settlements | (115,000) | 126,000 | -191% |
| Registration rights penalties | (109,000) | - | |
| Other income | 416,000 | - | |
| Other income (expense), net | (258,000) | (1,247,000) | -79% |

Interest expense: During 2009, the Company had significant increases in interest expense over 2008 as a result of the Company's borrowings it made during 2008 against its various credit facilities and for interest associated with a $900,000 Secured Promissory Note which the Company used to acquire its commercial printing business in December of 2008 which carried an annual interest rate of 12%.

Amortization of note discount: During 2009, the Company also recognized the amortization of note discount expense of approximately $247,000 for warrants that were issued in conjunction with the secured promissory note which had a fair value of approximately $256,000.

Loss on sale of patents: In 2008 the Company entered into an agreement with Trebuchet Capital Partners, LLC Pursuant to the Agreement, Trebuchet has agreed to pay substantially all of the litigation costs associated with pending validity proceedings initiated by the European Central Bank in eight European countries relating to the Company's European Patent 0 455 750B1 that the Company has claimed the ECB infringed in printing of the Euros currency. Under the terms of the Agreement, and in consideration for Trebuchet's funding obligations, the Company assigned and transferred a 49% interest of the Company's rights, title and interest in the Patent to Trebuchet which allows Trebuchet to have as a separate and exclusive interest including a separate and distinct right to exploit the Patent. Pursuant to this transaction, the Company recognized a loss on the sale of patent assets for its assignment and transfer of 49% of its ownership rights in the patent, which had a net book value of approximately $1,670,000, for $500,000, As a result, the Company recognized a loss on sale of patent assets of $1,170,000.

Gain on deconsolidation of Legalstore.com division: In October 2009, the Company sold its Legalstore.com division for a non-controlling interest (37% ownership interest) in Internet Media Services. The Company recognized a gain on the transaction of approximately $26,000 as the estimated fair value of consideration received in exchange for the assets and liabilities sold exceeded the Company's book value of the assets and liabilities.

The Company accounted for the deconsolidation of the business by recognizing a gain in net income, measured as the difference between: the fair value of the consideration received, which in the Company's case is a 37% equity interest in Internet Media Services, Inc. over the book value of the assets and liabilities transferred. The Company determined that the consideration received was not readily measurable because there was no activity in Internet Media Services, Inc. prior to the transaction. Therefore, the Company determined the value of the "business transferred" was more readily measurable and determined the fair value utilizing a discounted cash flow model.

Litigation settlements: On December 7, 2009, the Company reached an agreement to issue 40,000 shares of common stock valued at approximately $86,000 and 50,000 of common stock warrants valued at approximately $30,000 utilizing the Black Scholes option pricing model, for the purchase of common shares at $3.00 per share in connection with the settlement of certain litigation between the Company and the recipients. The shares and common stock warrants were recorded at the aggregate estimated fair value of $115,000. In 2008, the Company was awarded a judgment of approximately $126,000 pursuant to a counterclaim by the Company in the connection with certain litigation the Company won in June 2006.

Registration Rights Penalties: The Company recorded expense of approximately $110,000 for the fair value of 40,000 warrants to purchase the shares of the Company's common stock at $2.00 issuable to Printer's LLC as a result of the Company's failure to file a registration statement under the terms of the $450,000 Convertible Note the Company entered into in December 2009.

Other Income: The Company received $416,000 for New York State Qualified Emerging Technology Company ("QETC") refundable tax credit for the tax years ended 2005, 2006, and 2007 which the Company received in December, 2009.

**Net loss and loss per share**

| | Year Ended December 31, 2009 | Year Ended December 31, 2008 | % change |
|---|---|---|---|
| Net loss | $ (3,990,000) | $ (8,285,000) | -52% |
| Net loss per share, basic and diluted | $ (0.27) | $ (0.59) | -54% |
| Weighted average common shares outstanding, basic and diluted | 14,700,453 | 14,002,034 | 5% |

*Net loss and loss per share - 2009 vs 2008*

During 2009, the Company experienced a net loss of $4.0 million, a 52% decrease from the net loss of 2008. The decrease in reflects the significant decrease in other operating costs, along with the absence of a non-recurring loss on sale of patent which the Company incurred in 2008. These decreases more than offset increases in interest expense and amortization of note discount associated with the increase in debt incurred by the Company in the latter half of 2008 and during the first nine months of 2009.

**Liquidity and Capital Resources**

The Company's cash flows and other key indicators of liquidity are summarized as follows:

| | **As Of And For The Period Ended:** | | |
|---|---|---|---|
| | **December 31, 2009** | **December 31, 2008** | **% change vs. 2008** |
| Cash flows from: | | | |
| Operating activities | $ (1,595,000) | $ (2,391,000) | 33% |
| Investing activities | (108,000) | (2,266,000) | 95% |
| Financing activities | 2,064,000 | 4,002,000 | 48% |
| Working capital | (818,000) | (1,481,000) | -45% |
| Current ratio | 0.70☑ | 0.58☑ | 21% |
| Cash and cash equivalents | $ 449,000 | $ 88,000 | 410% |
| Funds Available from Open Credit Facilities | $ 417,000 | $ 1,317,000 | -68% |
| Debt (excluding unamortized debt discount) | $ 1,958,000 | $ 3,183,000 | -38% |

As of December 31, 2009, we had cash and cash equivalents of $449,000, representing an 410% increase over our December 31, 2008 cash position. As discussed below, the increase in the Company's cash position was primarily due to funds received from the issuance of equity offset by use of cash from operations.

Operating Cash Flow – During 2009, the Company used approximately $1.6 million of cash for operations, a 33% decrease in its use of cash for operations compared to 2008, which generally reflected the Company's increase in sales and the significant decrease in operating costs that the Company achieved during the year. Specifically, the Company realized the benefits of significant cost reductions that it initiated in 2008 and early 2009. In addition, during the fourth quarter of 2009, the Company received $412,000 from a New York State Qualified Emerging Technology Company tax refund that significantly improved the Company's 2009 operating cash flow. The Company used a portion of its cash to improve its working capital position to negative $818,000 from negative $1,481,000 at December 31, 2008.

Investing Cash Flow - During 2009, the Company used approximately $108,000 for investing activities. Specifically, the Company used $63,000 for capital equipment at its commercial printing plant and plastic printing plants, respectively, along with approximately $176,000 for payments for patent application fees. These expenditures were offset by the release of $131,000 from restricted cash. The Company does not have any material commitments for capital expenditures as of December 31, 2009, other than operating leases for certain equipment for its newly acquired commercial printing operation.

Financing Cash Flows – During 2009, the Company significantly improved its financial position by refinancing $1,350,000 of its shorter –term debt into longer term debt, raising $1.4 million in equity through the private placement of its common shares, and converting $2,000,000 in debt to equity. As of December 31, 2009, the Company had debt of $1,958,000, all of which is due on various date in 2012.

Future Capital Needs – The Company expects to use its existing cash to support its operations and its efforts to achieve consistent positive cash flow from operations. On February 12, 2010, the Company obtained $1,500,000 in secured debt and a $1,000,000 revolving line of credit in conjunction with its acquisition of Premier Packaging Corp. This acquisition, while adding to the Company's debt levels, is expected to improve the Company's operating cash flow in 2010 and beyond by adding a business that has historically generated positive cash flows, as well as by creating opportunities by integrating that business with existing product lines. During 2009, the Company raised approximately $1.4 million in net proceeds from the issuance of its Common Stock in private placements to accredited investors. Furthermore, as of December 31, 2009, the Company has approximately $449,000 in cash, $417,000 available to it under one credit facility and up to $1,000,000 available under a credit line at its Premier Packaging subsidiary acquired in 2010. In February 2010, the Company raised approximately $1.1 million through the exercise of warrants and sale of shares of common stock through private placements. The Company used approximately $600,000 of these funds towards the acquisition of Premier Packaging Corp. The remainder is available for working capital requirements. At its current revenue levels and with the impact of the Company's acquisition of Premier Packaging in February 2010, the Company expects its use of cash for operations to reduce during 2010 from the 2009 levels, and is striving to reach and maintain positive operating cash flows on a consistent basis in 2010, although there is no guarantee the Company will be able to do so. The Company's ability to fund its capital requirements out of its available cash and cash generated from its operations depends on a number of factors. Some of these factors include the Company's ability to (i) increase commercial and security printing and plastic card sales; (ii) increase sales of the Company's digital products; and (iii) integrate its new acquisition of Premier Packaging with its existing product lines. If the Company cannot generate sufficient cash from its operations, the Company may need to raise additional funds in the future in order to fund its working capital needs.

**Key Indicators of Future Results**

We believe that cash flow from operations is a significant key indicator for the Company. Our ability to reduce our use of cash will depend on our ability to grow revenue to a level sufficient to meet our operating expense requirements. To grow revenue, we may merge with or acquire manufacturing or related companies. Our ability to successfully complete these transactions on favorable terms will be a significant key indicator of our future results. These acquisitions may require additional funds that the Company does not currently have. To obtain additional investments in the future may require us to issue shares of our Common Stock. Our ability to sell our Common Stock on favorable terms will also be a significant key indicator of our future results. In addition, we believe that our ability to successfully enforce our patent rights, including our current litigation against the European Central Bank, is a significant key indicator for the Company.

**Off-Balance Sheet Arrangements**

We do not have any off-balance sheet arrangements that have, or are reasonably likely to have, an effect on our financial condition, financial statements, revenues or expenses.

**Inflation**

Although our operations are influenced by general economic conditions, we do not believe that inflation had a material effect on our results of operations during 2009 or 2008 as we are generally able to pass the increase in our material and labor costs to our customers, or absorb them as we improve the efficiency of our operations.

**Critical Accounting Policies**

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires management to make judgments, assumptions and estimates that affect the amounts reported in our consolidated financial statements and accompanying notes. The consolidated financial statements for the fiscal year ended December 31, 2009 describe the significant accounting policies and methods used in the preparation of the consolidated financial statements. Estimates are used for, but not limited to, the accounting for the allowance for doubtful accounts and sales returns, goodwill impairments, inventory allowances, revenue recognition, stock based compensation valuations, the valuation of intangible assets, and allocation of assets in business combinations. Actual results could differ from these estimates. The following critical accounting policies are impacted significantly by judgments, assumptions and estimates used in the preparation of our consolidated financial statements:

**Long Lived Assets**

The Company reviews long-lived assets and certain identifiable intangibles for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net undiscounted cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Fair value is determined based on discounted cash flows or appraised values, depending on the nature of the assets.

Fixed assets are carried at cost. Depreciation is computed over the estimated useful life of five to seven years using the straight-line depreciation method. Leasehold improvements are amortized over the shorter of their useful life or the lease term. Intangible assets consist primarily of royalty rights, contractual rights, customer list, and patent acquisition, application and defense costs. Amortization is computed over the estimated useful life of five to twenty years using the straight-line depreciation method. For patent related assets, the remaining legal life of the patent is used as the estimate useful life unless circumstances determine that the useful life will be less than the legal life. Long-lived assets to be held and used by the Company are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. We periodically evaluate the recoverability of our long-lived assets based on estimated future cash flows from and the estimated fair value of such long-lived assets, and provide for impairment if such undiscounted cash flows are insufficient to recover the carrying amount of the long-lived asset.

**Goodwill**

Goodwill is the excess of cost of an acquired entity over the fair value of amounts assigned to assets acquired and liabilities assumed in a business combination. Goodwill is not amortized, rather it is tested for impairment annually, and will be tested for impairment between annual tests if an event occurs or circumstances change that would indicate the carrying amount may be impaired. Impairment testing for goodwill is done at a reporting unit level. Reporting units are one level below the business segment level, but are combined when reporting units within the same segment have similar economic characteristics. The Company has three reporting units based on the current structure. An impairment loss generally would be recognized when the carrying amount of the reporting unit's net assets exceeds the estimated fair value of the reporting unit. The Company completed its assessment of any potential impairment upon adoption of this standard and performs annual assessments. Goodwill and indefinite-lived intangible assets are tested for impairment on an annual basis or sooner if an indicator of impairment occurs. To determine whether goodwill is impaired, we determine the fair values of each of our reportable business unit using a discounted cash flow methodology and then compare the fair values to the carrying values of each reportable business unit. The current Carrying value of goodwill of Document Security Systems is $631,000 with estimated discounted cash flow of $12,930,000 which includes projected cash flows from operations and estimated cash flow from successful results in infringement suits. The current carrying value of goodwill of Plastic Printing Professionals is $685,000 with an estimated discounted cash flow of $1,160,000 based on projected cash flows from operations. As of December 31, 2009, the 2009 annual testing date, the Company's market capitalization was approximately $40 million compared to stockholders' equity of $2.2 million. We have determined that a 10% decrease in the fair value of any one of our reporting units as of December 31, 2009 would have no impact on the carrying value of our goodwill. Though we believe our estimates are reasonable, these fair values require the use of management's assumptions, which would not reflect unanticipated events and circumstances that may occur.

**Other Intangible Assets and Patent Defense Costs**

Other intangible assets consists of costs associated with the application, acquisition and defense of the Company's patents, contractual rights to patents and trade secrets associated with the Company's technologies, a non-exclusive licensing agreement, and customer lists obtained as a result of acquisitions. The Company's patents and trade secrets are for document anti-counterfeiting and anti-scanning technologies and processes that form the basis of the Company's document security business. Patent application costs are capitalized and amortized over the estimated useful life of the patent, which generally approximates its legal life. External legal costs incurred to defend the Company's patents are capitalized to the extent of an evident increase in the value of the patents and an expected successful outcome, in accordance to guidance provided by FASB Concept Statement No. 6 and related guidance in AICPA Technical Questions and Answers, Section 2260, Other Assets, paragraph .03, "Legal Expenses Incurred to Defend Patent Infringement Suit". Patent defense costs are expensed at the point when it is determined that the outcome is expected to be unsuccessful. The Company capitalizes the cost of an appeal until it is determined that the appeal will be unsuccessful. The Company's capitalized patent defense costs expenses are analyzed for impairment based on the expected eventual outcome of the legal action and recoverability of proceeds or added economic value of the patent in excess of the costs. Legal actions related to the same patent defense case are unified into one asset group for the purposes on the impairment analysis. The Company amortizes its other intangible assets over their estimated useful lives. Patents are amortized over the remaining legal life, up to 20 years. Intangible asset amortization expense is generally classified as an operating expense. The Company believes that the decision to incur patent costs is discretionary as the associated products or services can be sold prior to or during the application process. The Company accounts for other intangible amortization as an operating expense, unless the underlying asset is directly associated with the production or delivery of a product. To date, the amount of related amortization expense for other intangible

assets directly attributable to revenue recognized is not material.

In December 2008, the Company recorded an impairment $361,000 for this license agreement the Company had acquired in 2006 for RSS Barcodes for which the Company assessed that the probable future cash flows derived from the license did not support the net carrying value of the license as of December 31, 2008.

On March 19, 2008, the Company received notification that its appeal of the invalidation of its European Paten 455750B1 in the UK was not successful. As a result of the adverse court decision, the Company recognized an impairment loss of $292,000 associated with the costs directly related to the UK appeal. The impairment loss includes a judgment for reimbursement of estimated counterpart legal fees. In January 2009, the Company received a formal request for the fee reimbursement from the ECB of $420,000 in addition to the amounts already paid by the Company. The Company hired an independent firm to assist the Company in reducing or eliminating the ECB's fees request, however, the Company recorded $145,000 as additional accrued expenses and an impairment loss as of December 31, 2008. On July 31, 2009, the UK court made the final assessment of costs for the UK patent validity case due from the Company to the ECB of ₤356,490, of which the Company has paid ₤332,000 pounds through December 31, 2009 and owes approximately ₤25,000 ($40,000 as of December 31, 2009), which amount was included in accrued expenses as of December 31, 2009.

On August 20, 2008, the Company entered into an agreement with Trebuchet Capital Partners, LLC ("Trebuchet") under which Trebuchet has agreed to pay substantially all of the litigation costs associated with pending validity proceedings initiated by the European Central Bank ("ECB") in eight European countries relating to the Company's European Patent 0 455 750B1 that the Company has claimed the ECB infringed in printing of the Euro currency (the "Patent"). Trebuchet also agreed to pay substantially all of the litigation costs associated with future validity challenges filed by the ECB or other parties, provided that Trebuchet elects to assume the defense of any such challenges, in its sole discretion, and patent infringement suits filed against the ECB and certain other alleged infringers of the Patent, all of which suits may be brought at the sole discretion of Trebuchet and may be in the name of the Company, Trebuchet or both. The Company provided Trebuchet with the sole and exclusive right to manage infringement litigation relating to the Patent in Europe, including the right to initiate litigation in the name of the Company, Trebuchet or both and to choose whom and where to sue, subject to certain limitations set forth in the agreement. Under the terms of the Agreement, the Company and Trebuchet have agreed to equally share all proceeds generated from litigation relating to the Patent, including judgments and licenses or other arrangements entered into in settlement of any such litigation. Trebuchet is also entitled to recoup any litigation expenses specifically awarded to the Company in such actions. Under the terms of the Agreement, and in consideration for Trebuchet's funding obligations, the Company assigned and transferred a 49% interest of the Company's rights, title and interest in the Patent to Trebuchet which allows Trebuchet to have a separate and distinct interest in and share of the Patent, along with the right to sue and recover in litigation, settlement or otherwise to collect royalties or other payments under or on account of the Patent. Pursuant to this transaction, the Company recognized a loss on the sale of patent assets for its assignment and transfer of 49% of its ownership rights in the patent, which had a net book value of approximately $1,670,000, for proceeds of $500,000, As a result, the Company recognized a loss on sale of patent assets of $1,170,000.

As of December 31, 2009, the Company had a net carrying value of approximately $1,589,000 of other intangible assets and patent defense costs of which $134,000 was acquired intangibles, $851,000 was patent acquisition and defense costs and $604,000 was patent application costs. The estimated cash flow that support the carrying values of these assets are derived at the reporting unit level, except for patent defense costs which are only supported by the estimated cash flow from successful results in infringement suits, if any.

**Conventional Convertible Debt**

When the convertible feature of the conventional convertible debt provides for a rate of conversion that is below market value, this feature is characterized as a beneficial conversion feature (BCF"). Prior to the determination of the BCF, the proceeds from the debt instrument were first allocated between the convertible debt and any embedded or detachable free standing instruments that are included, such as common stock warrants. We record a BCF as a debt discount pursuant to ASC Topic 470-20, formerly EITF Issue No. 98-5 (EITF 98-05"), Accounting for Convertible Securities with Beneficial Conversion Features or Contingency Adjustable Conversion Ratio," and EITF Issue No. 00-27, Application of EITF Issue No. 98-5 to Certain Convertible Instrument(s) ." In those circumstances, the convertible debt will be recorded net of the discount related to the BCF. We amortize the discount to interest expense over the life of the debt using the effective interest method.

**Revenue Recognition**

Sales of security and other printing products, and legal products are recognized when a product or service is delivered, shipped or provided to the customer and all material conditions relating to the sale have been substantially performed.

For digital solutions sales, revenue is recognized in accordance with the American Institute of Certified Public Accountant's Statement of Position (SOP) No. 97-2, "Software Revenue Recognition," as modified by SOP No. 98-9, "Modification of SOP No. 97-2, Software Revenue Recognition with Respect to Certain Transactions" and Staff Accounting Bulletin (SAB) No. 104, "Revenue Recognition." Accordingly, revenue is recognized when all of the following conditions are satisfied: (1) there is persuasive evidence of an arrangement; (2) the service or product has been provided to the customer; (3) the amount of fees to be paid by the customer is fixed or determinable (4) the collection of our fees is reasonably assured.

The Company recognizes revenue from technology licenses once all the following criteria for revenue recognition have been met: (1) persuasive evidence of an agreement exists; (2) the right and ability to use the product or technology has been rendered; (3)

the fee is fixed and determinable and not subject to refund or adjustment; and (4) collection of the amounts due is reasonably assured.

**Share-Based Payments**

We measure compensation cost for stock awards at fair value and recognize compensation expense over the service period for which awards are expected to vest. The Company uses the Black-Scholes option pricing model for determining the estimated fair value for stock-based awards. The Black-Scholes model requires the use of subjective assumptions which determine the fair value of stock-based awards, including the option's expected term and the price volatility of the underlying stock. For equity instruments issued to consultants and vendors in exchange for goods and services the Company determines the measurement date for the fair value of the equity instruments issued at the earlier of (i) the date at which a commitment for performance by the consultant or vendor is reached or (ii) the date at which the consultant or vendor's performance is complete. In the case of equity instruments issued to consultants, the fair value of the equity instrument is recognized over the term of the consulting agreement

The fair value of each option award is estimated on the date of grant utilizing the Black Scholes Option Pricing Model that uses the assumptions noted in the following table.

| | 2009 | 2008 |
|---|---|---|
| Volatility | 54.7% | 53.6% |
| Expected option term | 3.9years | 3.3years |
| Risk-free interest rate | 2.30% | 3.09% |
| Expected forfeiture rate | 0.0% | 0.0% |
| Expected dividend yield | 0.0% | 0.0% |

**Income Taxes**

Deferred tax assets and liabilities are determined based on temporary differences between income and expenses reported for financial reporting and tax reporting. FASB ASC 740 (formerly Statement of Financial Accounting Standards ("SFAS") No. 109, "Accounting for Income Taxes") requires that a valuation allowance be established when management determines that it is more likely than not that all or a portion of a deferred tax asset will not be realized. The Company evaluates the realizability of its net deferred tax assets on an annual basis an valuation allowances are provided or released, as necessary. Since the Company has had cumulative losses in recent years, the accounting guidance suggest that we should not look to future earnings to support the realizability of the net deferred tax asset. As a result, as of the years ended December 31, 2009 and 2008, the Company has elected to record a valuation allowance to reduce net deferred tax assets to zero.

The Company believes that the accounting estimates related to deferred tax valuation allowances are "critical accounting estimates" because: (1) the need for valuation allowance is highly susceptible to change from period to period due to changes in deferred tax asset and deferred tax liability balances, (2) the need for valuation allowance is susceptible to actual operating results and (3) changes in the tax valuation allowance can have a material impact on the tax provisions/benefit in the consolidated statements of operations and on deferred income taxes in the consolidated balance sheets.

**Investment Valuation and Deconsolidation**

On October 8, 2009, the Company entered into an Asset Purchase Agreement with Internet Media Services, Inc. whereby the Company sold the assets and liabilities of Legalstore.com, a division of the Company, in exchange for 7,500,000 shares of common stock of the Internet Media Services, Inc. The Company recorded its investment in Internet Media Services as an equity method investment at the fair market value of the business sold. Management determined that the transaction did not qualify as a non-monetary exchange due to the exception noted in ASC 845-10 ( [ A transfer of assets to an entity in exchange for an equity interest in that entity). Management determined that the transaction qualified as a derecoginition of a subsidiary under ASC 810-10-40. Therefore, the Company accounted for the deconsolidation of a subsidiary ("the business") by recording the consideration received at fair market value and recognizing a gain in net income measured as the difference between: the fair value of the consideration received (7,500,000 shares of common stock of Internet Media Services, Inc. or a 37% interest) and the carrying value of the assets and liabilities sold. Given that the consideration received is not readily measurable because of the lack of activity in Internet Media Services, Inc. prior to the transaction, the Company determined that the value of the "business transferred" is more readily measurable. The Company determined the fair market value of the business transferred based on a discounted cash flow model. The Company is recording the equity method investment at fair value. Under the equity method investment the Company is required to account for the difference between the cost of an investment and the amount of the underlying equity in net assets of an investee as if the investee were a consolidated subsidiary. If the investor is unable to relate the difference to specific accounts of the investee (*e.g.*, property and equipment), the difference should be considered to be the same as goodwill. Investors shall not amortize goodwill associated with equity method investments after the date ASC 350/Statement No. 142, *Goodwill and Other Intangible Assets*, is initially applied by the entity in its entirety. The Company has determined that given the lack of activity in Internet Media Services, Inc. prior to the transaction, the difference between the cost of the investment (fair market value) and the underlying equity interest is attributable to goodwill. The Company is continuing to report the activity in operating loss and not breaking out and reporting it as discontinued operations because the operations and cash flows of the component have not been eliminated from the ongoing

operations of the entity as a result of the equity method investment and because the Company will have significant continuing involvement in the operations of Internet Media Services, Inc. after the disposal transaction because of the ownership percentage and the board representation.

**ITEM 8 - FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

Our audited financial statements for the fiscal years ended December 31, 2009 and 2008 follow Item 14, beginning at page F-1.

**ITEM 9 - CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None

**ITEM 9A(T) - CONTROLS AND PROCEDURES**

**Evaluation of Disclosure Controls and Procedures**

Management is responsible for establishing and maintaining effective disclosure controls and procedures. As of December 31, 2009, our Chief Executive Officer and Chief Financial Officer participated with our management in evaluating the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")). Our disclosure controls and procedures are designed to ensure that information required to be disclosed in the Securities and Exchange Commission ("SEC") reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time period specified by the SEC's rules and forms and that such information is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure. In light of the discussion of material weaknesses set forth below, these officers have concluded that our disclosure controls and procedures were not effective as of December 31, 2009. To the best of their knowledge, management believes that the financial statements included in this Annual Report on Form 10-K fairly present, in all material respects, our financial condition, results of operations and cash flows for the periods presented in conformity with accounting principles generally accepted in the United States of America (US GAAP).

**Management's Annual Report on Internal Control Over Financial Reporting**

A company's internal control over financial reporting is a process designed by, or under the supervision of, a public company's principal executive and principal financial officers, or persons performing similar functions, and effected by the board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles ("GAAP") including those policies and procedures that: (i) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company, (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures are being made only in accordance with authorizations of management and directors of the company, and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Management is responsible for establishing and maintaining adequate internal control over financial reporting. Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has assessed the effectiveness of our internal control over financial reporting as of December 31, 2009. In making this assessment, our management used the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

A material weakness is a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a material misstatement of the annual or interim financial statements will not be prevented or detected on a timely basis. In connection with management's assessment of our internal control over financial reporting described above, management has identified the following material weaknesses in the Company's internal control over financial reporting as of December 31, 2009:

We did not maintain a sufficient complement of qualified accounting personnel and controls associated with segregation of duties were ineffective. During 2009 we had one person on staff that performs nearly all aspects of our external financial reporting process, including but not limited to access to the underlying accounting records and systems, the ability to post and record journal entries and responsibility for the preparation of the external financial statements. This creates certain incompatible duties and a lack of review over the financial reporting process that would likely fail to detect errors in spreadsheets, calculations, or assumptions used to compile the financial statements and related disclosures as filed with the SEC. Specifically, we determined that our controls over the preparation, review and monitoring of the financial statements were ineffective to provide reasonable assurance that financial disclosures agreed to appropriate supporting detail, calculations or other documentation. In addition, during the preparation of our annual consolidated financial statements, we determined that certain key assumptions and calculations used in the future cash flow analysis supporting our asset impairment tests required editing after submission to our auditors. These edits did not result in audit adjustments to our December 31, 2009 consolidated financial statements. These control deficiencies could result in a material misstatement to our interim or annual consolidated financial statements that would not be prevented or detected.

Controls associated with identifying and accounting for complex and non-routine transactions in accordance with U.S. generally accepted accounting principles were ineffective. Specifically, during the course of the quarterly interim reviews and the annual audit, audit adjustments were made to correct the recorded amounts for certain deconsolidation, and debt and equity based transactions, including the resulting impact on out income tax provision, as well as required disclosures based on the misapplication of GAAP by the Company that would have resulted in a material misstatement of our financial statements.

As a result of the material weaknesses described above, our management concluded that as of December 31, 2009, we did not maintain effective internal control over financial reporting based on the criteria established in *Internal Control—Integrated Framework* issued by the COSO.

This annual report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the Company to provide only Management's report in this annual report.

***Plan for Remediation of Material Weaknesses***

In response to the identified material weaknesses, management, with oversight from the Company's audit committee, plans to review our control environment and to evaluate whether cost effective solutions are available to remedy the identified material weaknesses by expanding the resources available to the financial reporting process.

Notwithstanding the material weaknesses discussed above, management believes that the financial statements included in this report present fairly, in all material respects, our financial position, results of operations, and cash flows for the periods presented in accordance with U.S. generally accepted accounting principles.

***Changes in Internal Control over Financial Reporting***

There have been a number of changes made to our internal control over financial reporting (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act) during 2009. Specifically, the Company added one divisional controller as the result of the Company's acquisition of a commercial printing. The Company began implement a new accounting and estimating system at its printing division in order to improve the efficiency and effectiveness of reporting and workflow at that operation. After which, the Company expects to utilize the financial resources that become available after the system implementation to improve its areas of deficiency in the financial reporting process.

## PART III

### ITEM 10 - DIRECTORS, EXECUTIVE OFFICERS, CORPORATE GOVERNANCE

The information required by this Item will be contained in the Company's Proxy Statement for its Annual Stockholders Meeting, which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2009, and which is incorporated by reference herein.

We make available free of charge through the investor relations page of our Web site (www.documentsecurity.com) our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports, and all beneficial ownership reports on Forms 3, 4 and 5 filed by directors, officers and beneficial owners of more than 10% of our equity, as soon as reasonably practicable after such reports are electronically filed with the Securities and Exchange Commission. We have adopted codes of business conduct and ethics for all of our employees, including our principal executive officer, principal financial officer and principal accounting officer. Copies of the codes of business conduct and ethics are available on our Web site.

Our Web sites and the information contained therein or incorporated therein are not intended to be incorporated into this Annual Report on Form 10-K or our other filings with the SEC.

### ITEM 11 - EXECUTIVE COMPENSATION

The information required by this Item will be contained in the Company's Proxy Statement for its Annual Stockholders Meeting, which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2009, and which is incorporated by reference herein.

### ITEM 12 - SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this Item will be contained in the Company's Proxy Statement for its Annual Stockholders Meeting, which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2009, and which is incorporated by reference herein.

### ITEM 13 - CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this Item will be contained in the Company's Proxy Statement for its Annual Stockholders Meeting, which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2009, and which is incorporated by reference herein.

### ITEM 14 - PRINCIPAL ACCOUNTING FEES AND SERVICES

The information required by this Item will be contained in the Company's Proxy Statement for its Annual Stockholders Meeting, which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2009, and which is incorporated by reference herein.

### ITEM 15 - EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

**(a) Exhibits**

The Exhibits listed below designated by an * are incorporated by reference to the filings by Document Security Systems, Inc. under the Securities Act of 1933 or the Securities and Exchange Act of 1934, as indicated. All other exhibits are filed herewith.

| | |
|---|---|
| 3.1 | Articles of Organization, as amended (incorporated by reference to exhibit 3.1 to the Company's Registration Statements No. 2-98684-NY on Form S-18).* |
| 3.2 | By-laws, as amended (incorporation by reference to exhibit 3.2 to the Company's Registration Statement No. 2-98684-NY on Form S-18).* |
| 10.1 | Agreement dated November 7, 1996 with Charles M. LaLoggia (incorporated by reference from Company's Form 10-Q for March 31, 1997).* |
| 10.2 | Agreement dated July 2, 1996 with Frank LaLoggia (incorporated by reference from Company's Form 10-Q for June 30, 1996).* |
| 10.3 | Agreement dated July 31, 2002 between New Sky Communications, Inc. and Patrick White (incorporated by reference from Company's Form 8-K filed on August 8, 2002).* |

| | |
|---|---|
| 10.4 | Agreement dated July 31, 2002 between New Sky Communications, Inc. and Thomas M. Wicker (incorporated by reference from Company's Form 8-K filed on August 8, 2002).* |
| 10.5 | Agreement dated November 1, 2002 between New Sky Communications, Inc. and David Thomas M. Wicker, Christine Wicker, Kenneth Wicker and Michael Caton (incorporated by reference to the Registrant's Form 10-KSB for the fiscal year ended December 31, 2002). * |
| 10.6 | Employment Agreement dated November 1, 2002 between New Sky Communications, Inc. and David Wicker (incorporated by reference to the Registrant's Form 10-KSB for the fiscal year ended December 31, 2002). * |
| 10.7 | Form of Warrant Agreement between the Registrant and Fordham Financial Management, Inc.(incorporated by reference on Company's registration statement on Form S-3 filed on January 20, 2004).* |
| 10.8 | Form of Warrant Agreement between the Registrant and W.A.B. Capital (incorporated by reference on Company's registration statement on Form S-3 filed on January 20, 2004).* |
| 10.9 | Form of Warrant Agreement between the Registrant and Howard Safir (incorporated by reference on Company's registration statement on Form S-3 filed on January 20, 2004).* |
| 10.10 | Form of Series A Warrant Agreement issued by the Registrant to participants in its private placement offering completed on December 29, 2003. (incorporated by reference on Company's registration statement on Form S-3 filed on January 20, 2004).* |
| 10.11 | Form of Registration Rights Agreement issued by the Registrant to participants in its private placement offering completed on December 29, 2003. (incorporated by reference on Company's registration statement on Form S-3 filed on January 20, 2004)* |
| 10.12 | Form of Warrant issued to IDT Venture Capital Corporation dated October 31, 2003.(incorporated by reference on Schedule 13D filed by IDT Venture Capital Corporation dated December 2, 2003)* |
| 10.13 | Form of Securities Purchase Agreement between Registrant and IDT Venture Capital Corporation dated as of October 31, 2003. (incorporated by reference on Schedule 13D filed by IDT Venture Capital Corporation dated December 2, 2003).* |
| 10.14 | Form of Licensing and Marketing Agreement between Registrant and Boise White Paper LLC dated January 19, 2005. (redacted version) |
| 10.15 | Form of Surrender and Assignment Agreement dated as of February 25, 2005 between Registrant and the Net Interest Holders. (filed as Exhibit 10.1 to form 8-K dated February 25, 2005)* |
| 10.16 | Form of Surrender and Assignment Agreement dated as of February 25, 2005 between Registrant and the Gross Interest Holders (filed as Exhibit 10.2 to Form 8-K dated February 25, 2005)* |
| 10.17 | Agreement of Sublease dated May 2004 for the Premises Located at 28 E. Main Street, Rochester, New York (filed as Exhibit 10.1 to Form 10-QSB for the Quarter ended June 30, 2004)* |
| 10.18 | Form of Employment Agreement dated as of June 10, 2004 between Registrant and Patrick White (filed as Exhibit 10.2 to Form 10-QSB for the Quarter ended June 30, 2005)* |
| 10.19 | Form of Employment Agreement dated as of June 11, 2004 between Registrant and Thomas Wicker (filed as Exhibit 10.26 of 10-KSB for the fiscal year ended December 31, 2004)* |
| 10.20 | Form of 2004 Employee Stock Option Plan (filed as Appendix D to Proxy Statement for the Meeting of Stockholders held on December 17, 2004)* |
| 10.21 | Form of Non Executive Director Stock Option Plan (filed as Appendix E to Proxy Statement for the Meeting of Stockholders held on December 17, 2004)* |
| 10.22 | Asset Purchase Agreement, dated February 7, 2006 by and between the Registrant and Plastic Printing Professionals, Inc. . (filed as exhibit 10.30 to Form 10-KSB for the fiscal year ended December 31, 2005)* |
| 10.23 | Stock Option Agreement pursuant to the Registrant's 2004 Employee Stock Option Plan (filed as exhibit 10.31 to Form S-8 filed May 12, 2006)* |
| 10.24 | Warrant and Amendment to Warrant dated June 16, 2006, granted to International Barcode Corporation (filed as exhibit 10.33 and 10.34 respectively to Form 10-Q for the quarter ended June 30, 2007)* |
| 10.25 | License and Distribution Agreement dated November 8, 2006 by and between the Registrant and PT Sekur Grafika (filed as exhibit 10.30 to Form 10-Q for the quarter ended June 30, 2007)* |
| 10.26 | Form of Subscription Agreement by and between the Registrant and investors in a Private Placement (filed as Exhibit 10.1 to Form 8-K/A dated December 27, 2006)* |
| 10.27 | Registration Rights Agreement dated December 12, 2006 between the Registrant and Perrin, Holden &Davenport Capital Corp. as agent for those investing in a Private Placement (filed as Exhibit 10.2 to Form 8-K/A dated December 27, 2006)* |
| 10.28 | Form of Common Stock Purchase Warrant granted pursuant to a Private Placement (filed as Exhibit 4.1 to Form 8-K/A dated December 27, 2006)* |
| 10.29 | Limited Exclusive Patent License Agreement dated December 29, 2006 between the Registrant and Ergonomic Group, Inc. (filed as exhibit 10.31 to Form 10-Q for the quarter ended June 30, 2007)* |

| | |
|---|---|
| 10.30 | Letter Agreement dated June 11, 2007 between the Registrant and International Barcode Corporation (BTI) (filed as exhibit 10.35 to Form 10-Q for the quarter ended June 30, 2007)* |
| 10.31 | License and Distribution Agreement dated June 27, 2007 by and between the Registrant and Cultura Interactiva S.A. de C.V. (filed as exhibit 10.32 to Form 10-Q for the quarter ended June 30, 2007)* |
| 10.32 | Credit Facility Agreement, dated January 4, 2008, between the Registrant and Fagenson & Co., Inc., as Agent |
| 10.33 | Security Agreement, dated January 4, 2008, between the Registrant and Fagenson & Co., Inc., as Agent |
| 10.34 | Form of Secured Promissory Note between the Registrant and Fagenson & Co., Inc., as Agent |
| 10.35 | Credit Facility Agreement, dated January 4, 2008, between the Registrant and Patrick White |
| 10.36 | Security Agreement, dated January 4, 2008, between the Registrant and Patrick White |
| 10.37 | Form of Secured Promissory Note between the Registrant and Patrick White |
| 10.38 | Agreement, dated April 11, 2008, between the Registrant and Ergonomic Group (filed as exhibit 10.1 to Form 8-K dated April 11, 2008)* |
| 10.39 | Credit Facility Note, dated May 7, 2008, between the Registrant and Taiko III Corp. (filed as exhibit 10.1 to Form 8-K dated May 7, 2008)* |
| 10.40 | Confidential Separation Agreement and General Release, dated May 10, 2008, between Peter Ettinger and the Company (filed as exhibit 10.1 to Form 8-K dated May 10, 2008)* |
| 10.41 | Consulting Agreement, dated May 12, 2008, between Peter Ettinger and the Company (filed as exhibit 10.2 to Form 8-K dated May 10, 2008)* |
| 10.42 | Share Purchase Agreement, dated as of June 25, 2008, between the Registrant and Walton Invesco Inc. (filed as exhibit 10.1 to Form 10-Q for the quarter ended June 30, 2008)* |
| 10.43 | Share Purchase Agreement, dated as of June 25, 2008, between the Registrant and Walton Invesco Inc. (filed as exhibit 10.2 to Form 10-Q for the quarter ended June 30, 2008)* |
| 10.44 | Asset Purchase Agreement, dated as of November 6, 2008, among Secuprint Inc., DPI of Rochester, LLC, James Stanley and Matthew Kellman (filed as exhibit 10.1 to Form 8-K dated November 6, 2008)* |
| 10.45 | Agreement, dated August 20, 2008, between Document Security Systems, Inc. and Trebuchet Capital Partners, LLC (filed as exhibit 10.1 to Form 10-Q for the quarter ending September 30, 2008)* |
| 10.46 | Warrant, dated December 18, 2008, of Document Security Systems, Inc. issued to Baum Capital Investments Inc. (filed as exhibit 4.1 to Form 8-K dated December 22, 2008)* |
| 10.47 | Secured Promissory Note, dated December 18, 2008, between Document Security Systems, Inc. , Secuprint Inc. and Baum Capital Investments Inc. (filed as exhibit 10.2 to Form 8-K dated December 22, 2008)* |
| 10.48 | Security Agreement, dated December 18, 2008, between Secuprint Inc. and Baum Capital Investments Inc. (filed as exhibit 10.3 to Form 8-K dated December 22, 2008)* |
| 10.49 | Form of Registration Rights Agreement dated as of May 29, 2009 executed and delivered by Document Security Systems, Inc. and the holders listed therein. (filed as exhibit 10.2 to Form 8-K dated May 29, 2009)* |
| 10.50 | Form of Warrant to Purchase Common Stock of Document Security Systems, Inc. dated May 29, 2009. (filed as exhibit 4.1 to Form 8-K dated May 29, 2009)* |
| 10.51 | Form of Subscription Agreement dated as of May 29, 2009 between Document Security Systems, Inc. and the Subscribers. (filed as exhibit 10.1 to Form 8-K dated May 29, 2009)* |
| 10.52 | Asset Purchase Agreement between Lester Levin Inc. and Internet Media Services, Inc. dated October 8, 2009. (filed as exhibit 10.1 to Form 8-K dated October 8, 2009)* |
| 10.53 | Stock Pledge and Escrow Agreement between Lester Levin Inc., Document Security Systems, Inc., Internet Media Services, Inc., Michael Buechler and Manufacturers and Traders Trust Company dated October 8, 2009. (filed as exhibit 10.3 to Form 8-K dated October 8, 2009)* |
| 10.54 | Stock Pledge and Escrow Agreement between Lester Levin Inc., Document Security Systems, Inc., Internet Media Services, Inc., Raymond Meyers and Manufacturers and Traders Trust Company dated October 8, 2009. (filed as exhibit 10.2 to Form 8-K dated October 8, 2009)* |
| 10.55 | Voting Agreement between Document Security Systems, Inc., Internet Media Services, Inc., Raymond Meyers and Michael Buechler dated October 8, 2009. (filed as exhibit 10.4 to Form 8-K dated October 8, 2009)* |
| 10.55 | $350,000 Convertible Promissory Note dated November 24, 2009. (filed as exhibit 10.1 to Form 8-K dated December 15, 2009)* |
| 10.56 | $575,000 Promissory Note dated November 24, 2009. (filed as exhibit 10.2 to Form 8-K dated December 15, 2009)* |
| 10.57 | Form of Letter Agreement dated December 11, 2009. (filed as exhibit 10.3 to Form 8-K dated December 15, 2009)* |
| 10.58 | Form of Letter Agreement dated December 11, 2009 |
| 10.59 | Form of $450,000 Convertible Promissory Note. (filed as exhibit 10.1 to Form 8-K dated December 30, 2009)* |

| | |
|---|---|
| 21 | Subsidiaries of Registrant |
| 23.1 | Consent of Freed Maxick & Battaglia, CPAs, PC |
| 31.1 | Certification of Chief Executive Officer Pursuant to 18 USC 1350 Section 302 |
| 31.2 | Certification Principal Accounting Officer Pursuant to 18 USC 1350 Section 302 |
| 32.1 | Certification of Chief Executive Officer Pursuant to 18 USC 1350 Section 906 |
| 32.2 | Certification Principal Accounting Officer Pursuant to 18 USC 1350 Section 906 |

(1) This exhibit contains a redacted copy of the agreement. We have filed a confidentiality request with the Commission with respect to certain portions of the agreement.

**DOCUMENT SECURITY SYSTEMS, INC. AND SUBSIDIARIES**

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders
Document Security Systems, Inc. and Subsidiaries

We have audited the accompanying consolidated balance sheets of Document Security Systems, Inc. and Subsidiaries as of December 31, 2009 and 2008, and the related consolidated statements of operations, stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor have we been engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Document Security Systems, Inc. and Subsidiaries as of December 31, 2009 and 2008, and the results of its operations and its cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

FREED MAXICK & BATTAGLIA, CPAs, PC
/s/ FREED MAXICK & BATTAGLIA, CPAs, PC

Buffalo, New York
March 24, 2010

## DOCUMENT SECURITY SYSTEMS, INC. AND SUBSIDIARIES
### Consolidated Balance Sheets
### As of December 31,

| | 2009 | 2008 |
|---|---|---|
| **ASSETS** | | |
| | | |
| **Current assets:** | | |
| Cash and cash equivalents | $ 448,895 | $ 87,820 |
| Restricted cash | - | 131,004 |
| Accounts receivable, net of allowance of $66,000 ($50,000- 2008) | 1,143,939 | 1,284,208 |
| Inventory | 184,174 | 359,034 |
| Loans to employees | - | 67,781 |
| Prepaid expenses and other current assets | 91,310 | 75,066 |
| Total current assets | 1,868,318 | 2,004,913 |
| | | |
| **Fixed assets, net** | 1,286,226 | 1,517,357 |
| **Other assets** | 305,507 | 264,529 |
| **Investment** | 350,000 | - |
| **Goodwill** | 1,315,721 | 1,396,734 |
| **Other intangible assets, net** | 1,588,969 | 2,873,789 |
| | | |
| **Total assets** | $ 6,714,741 | $ 8,057,322 |
| | | |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| | | |
| **Current liabilities:** | | |
| Accounts payable | $ 1,673,901 | $ 1,411,942 |
| Accrued expenses & other current liabilities | 909,432 | 1,312,745 |
| Deferred revenue & customer deposits | 25,163 | 30,193 |
| Short-term debt, net of unamortized discount of $247,000 -2008 | - | 652,511 |
| Current portion of capital lease obligations | 78,167 | 78,367 |
| | | |
| Total current liabilities | 2,686,663 | 3,485,758 |
| | | |
| **Revolving notes from related parties** | 583,000 | 2,283,000 |
| **Long term debt, net of unamortized discount of $420,000 ($0 -2008)** | 954,616 | - |
| **Capital lease obligations** | 182,424 | 210,365 |
| **Deferred tax liability** | 70,830 | 51,878 |
| | | |
| **Commitments and contingencies (see Note 13)** | | |
| | | |
| **Stockholders' equity** | | |
| Common stock, $.02 par value; 200,000,000 shares authorized, 16,397,887 shares issued and outstanding (14,369,764 in 2008) (325,000 subscribed in 2008) | 327,957 | 287,395 |
| Additional paid-in capital | 38,399,033 | 35,538,695 |
| Common stock subscriptions receivable | - | (1,300,000) |
| Accumulated deficit | (36,489,782) | (32,499,769) |
| Total stockholders' equity | 2,237,208 | 2,026,321 |
| **Total liabilities and stockholders' equity** | $ 6,714,741 | $ 8,057,322 |

See accompanying notes.

**DOCUMENT SECURITY SYSTEMS, INC. AND SUBSIDIARIES**

**Consolidated Statements of Operations**

For the Years Ended December 31,

| | 2009 | 2008 |
|---|---|---|
| Revenue | | |
| Security and commercial printing | $ 8,773,131 | $ 4,386,552 |
| Technology license royalties and digital solutions | 783,453 | 1,646,648 |
| Legal products | 355,107 | 609,807 |
| Total Revenue | 9,911,691 | 6,643,007 |
| Costs of revenue | | |
| Security and commercial printing | 6,063,479 | 2,663,309 |
| Technology license royalties and digital solutions | 14,028 | 14,028 |
| Legal products | 178,892 | 351,769 |
| Total costs of revenue | 6,256,399 | 3,029,106 |
| **Gross profit** | 3,655,292 | 3,613,901 |
| **Operating expenses:** | | |
| Selling, general and administrative | 5,733,908 | 7,431,313 |
| Research and development | 291,538 | 432,550 |
| Impairment of patent defense costs and other intangible assets | - | 797,143 |
| Amortization of intangibles | 1,342,105 | 1,972,233 |
| Operating expenses | 7,367,551 | 10,633,239 |
| **Operating loss** | (3,712,259) | (7,019,338) |
| **Other income (expense):** | | |
| Interest income | 18,140 | 658 |
| Gain (loss) on foreign currency transactions | 15,050 | (59,094) |
| Interest expense | (258,918) | (136,306) |
| Amortizaton of note discount | (250,102) | (8,227) |
| Loss on sale of patent assets | - | (1,169,947) |
| Gain on deconsolidation of Legalstore.com division | 25,755 | - |
| Litigation settlements | (115,101) | 126,073 |
| Registration rights penalties | (109,464) | - |
| Other income | 415,838 | - |
| **Loss before income taxes** | (3,971,061) | (8,266,181) |
| Income tax expense | 18,952 | 18,961 |
| **Net loss** | $ (3,990,013) | $ (8,285,142) |
| **Net loss per share -basic and diluted:** | $ (0.27) | $ (0.59) |
| **Weighted average common shares outstanding, basic and diluted** | 14,700,453 | 14,002,034 |

See accompanying notes.

## DOCUMENT SECURITY SYSTEMS, INC. AND SUBSIDIARIES
### Consolidated Statements of Cash Flows
### For the Years Ended December 31,

| | 2009 | 2008 |
|---|---|---|
| **Cash flows from operating activities:** | | |
| Net loss | $ (3,990,013) | $ (8,285,142) |
| Adjustments to reconcile net loss to net cash used by operating activities: | | |
| Depreciation and amortization | 1,661,522 | 2,288,061 |
| Stock based compensation | 67,709 | 1,747,368 |
| Stock based payments for legal settlements | 115,101 | - |
| Warrants issuable for registration rights penalty | 109,464 | - |
| Impairment of patent defense costs and other intangible assets | - | 797,143 |
| Amortization of note discount | 250,102 | 8,227 |
| Gain on deconsolidation of division | (25,755) | |
| Loss of sale of patent assets | - | 1,169,947 |
| Decrease in restricted cash for foreign currency loss | - | 46,341 |
| (Increase) decrease in assets: | | |
| Accounts receivable | 109,108 | 209,399 |
| Inventory | 73,849 | (32,342) |
| Prepaid expenses and other assets | (81,547) | (36,653) |
| Increase (decrease) in liabilities: | | |
| Accounts payable | 276,070 | 31,096 |
| Accrued expenses and other liabilities | (155,681) | 383,884 |
| Deferred revenue and customer deposits | (5,030) | (718,100) |
| Net cash used by operating activities | (1,595,101) | (2,390,771) |
| | | |
| **Cash flows from investing activities:** | | |
| Purchase of fixed assets | (62,522) | (334,800) |
| Decrease in restricted cash | 131,004 | - |
| Acquisition of business | - | (1,082,537) |
| Proceeds from the sale of patent assets | - | 500,000 |
| Purchase of other intangible assets | (176,083) | (1,348,666) |
| Net cash used by investing activities | (107,601) | (2,266,003) |
| | | |
| **Cash flows from financing activities:** | | |
| Borrowing on revolving note- related parties | 1,030,000 | 1,983,000 |
| Repayment on revolving note- related parties | (730,000) | - |
| Borrowings on short-term credit facility | - | 500,000 |
| Repayment on short-term credit facility | - | (500,000) |
| Borrowings on short- term debt | - | 900,000 |
| Payments on short-term debt | (900,000) | - |
| Borrowings on long-term debt | 575,000 | - |
| Borrowings on long-term convertible notes | 800,000 | - |
| Payments of capital lease obligations | (86,124) | (86,037) |
| Issuance of common stock, net | 1,374,901 | 1,205,163 |
| Net cash provided by financing activities | 2,063,777 | 4,002,126 |
| | | |
| **Net increase (decrease) in cash and cash equivalents** | 361,075 | (654,648) |
| **Cash and cash equivalents beginning of period** | 87,820 | 742,468 |
| | | |
| **Cash and cash equivalents end of period** | $ 448,895 | $ 87,820 |

See accompanying notes.

**DOCUMENT SECURITY SYSTEMS, INC. AND SUBSIDIARIES**
**Consolidated Statements of Changes in Stockholders' Equity**
**For the Years Ended December 31, 2009 and 2008**

| | Common Stock | | Additional Paid- | Subscriptions | Accumulated | |
|---|---|---|---|---|---|---|
| | **Shares** | **Amount** | **in Capital** | **Receivable** | **Deficit** | **Total** |
| **Balance, December 31, 2007** | **13,654,364** | **$ 273,087** | **$ 31,298,571** | **$ -** | **$ (24,214,627)** | **$ 7,357,031** |
| Shares issued upon the exercise of warrants and options | 50,000 | 1,000 | 99,000 | - | - | 100,000 |
| Stock based payments | 65,400 | 1,308 | 1,497,407 | - | - | 1,498,715 |
| Warrants issued with debt | - | - | 255,717 | - | - | 255,717 |
| Issuance of common stock, net | 600,000 | 12,000 | 2,388,000 | (1,300,000) | - | 1,100,000 |
| Net Loss | - | - | - | - | (8,285,142) | (8,285,142) |
| **Balance, December 31, 2008** | **14,369,764** | **$ 287,395** | **$ 35,538,695** | **$ (1,300,000)** | **$ (32,499,769)** | **$ 2,026,321** |
| Issuance of common stock, net | 1,010,000 | 20,200 | 1,354,702 | - | - | 1,374,902 |
| Conversion of debt to equity | 1,250,000 | 25,000 | 1,975,000 | - | | 2,000,000 |
| Discount on debt and beneficial conversion features | | | 422,997 | - | | 422,997 |
| Stock based payments | 93,123 | 1,862 | 401,139 | - | - | 403,001 |
| Cancellation of subscribed shares | (325,000) | (6,500) | (1,293,500) | 1,300,000 | | - |
| Net Loss | | | | - | (3,990,013) | (3,990,013) |
| **Balance, December 31, 2009** | **16,397,887** | **$ 327,957** | **$ 38,399,033** | **$ -** | **$ (36,489,782)** | **$ 2,237,208** |

See accompanying notes.

**NOTE 1. - DESCRIPTION OF BUSINESS**

Document Security Systems, Inc. (the “Company”), a New York corporation, and its subsidiaries, primarily operates in the security and commercial printing markets. The Company develops, patents, markets produces and licenses technology that prevents documents from unauthorized copying, scanning and counterfeiting. The Company also provides commercial print services for high quality documents produced on offset and digital presses, along with plastic documents and ID’s that include embedded electronics, such as RFID (Radio Frequency Identification) and variable data magnetic strips. The Company’s customers include governments, law enforcement agencies, security printers, check and forms printers and corporations.

**NOTE 2. - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

***Principles of Consolidation*** - The consolidated financial statements include the accounts of Document Security Systems, Inc. and its subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

***Use of Estimates*** - The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions that affect the amounts reported and disclosed in the financial statements and the accompanying notes. Actual results could differ materially from these estimates. On an ongoing basis, we evaluate our estimates, including those related to the accounts receivable, fair values of intangible assets and goodwill, useful lives of intangible assets and property and equipment, fair values of options and warrants to purchase our common stock, deferred revenue and income taxes, among others. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities. We engage third-party valuation consultants to assist management in the allocation of the purchase price of significant acquisitions.

***Reclassifications*** - Certain prior year amounts have been reclassified to conform to the current year presentation.

***Cash and Cash Equivalents***– The Company maintains its cash in bank deposit accounts and, from time to time, short term Certificates of Deposits with original maturities of three months or less. For financial statement presentation purposes, the Company considers those short-term, highly liquid investments with original maturities of three months or less to be cash or cash equivalents.

***Restricted Cash*** - In July 2007, the Company established a restricted cash balance of 87,500 British pounds, as collateral for a deed of guarantee that was required by the English Court of Appeals in order for the Company to pursue an appeal in that court. On March 19, 2008, the Company was notified that its appeal was denied and that the Company owed the European Central Bank, the successful party in the appeal, the 87,500 British pounds. Final assessment by the Court was made on July 31, 2009 and in August 2009, the funds were used to pay a portion of the appeal costs owed by the Company.

***Accounts Receivable*** - The Company carries its trade accounts receivable at invoice amount less an allowance for doubtful accounts. On a periodic basis, the Company evaluates its accounts receivable and establishes an allowance for doubtful accounts based upon management’s estimates that include a review of the history of past write-offs and collections and an analysis of current credit conditions. At December 31, 2009 the Company established a reserve for doubtful accounts of approximately $66,000 ($50,000 – 2008). The Company does not accrue interest on past due accounts receivable.

***Inventory*** - Inventories consist primarily of paper, plastic materials and cards, pre-printed security paper, and legal supplies held for resale and are stated at the lower of cost or market on the first-in, first-out (“FIFO”) method.

***Fixed Assets -*** Fixed assets are recorded at cost. Depreciation is computed using the straight-line method over the estimated useful lives or lease period of the assets whichever is shorter. Expenditures for renewals and betterments are capitalized. Expenditures for minor items, repairs and maintenance are charged to operations as incurred. Any gain or loss upon sale or retirement due to obsolescence is reflected in the operating results in the period the event takes place. Depreciation expense in 2009 was approximately $319,000 ($316,000- 2008).

***Investment*** - On October 8, 2009, the Company entered into an Asset Purchase Agreement with Internet Media Services, Inc. whereby the Company sold the assets and liabilities of Legalstore.com, a division of the Company, in exchange for 7,500,000 shares of common stock of the Internet Media Services, Inc. The Company recorded its investment in Internet Media Services as an equity method investment at the fair market value of the business sold. Management determined that the transaction qualified as a derecoginition of a subsidiary under ASC 810-10-40. Therefore, the Company accounted for the deconsolidation of a subsidiary ("the business") by recording the consideration received at fair market value and recognizing a gain in net income measured as the difference between: the fair value of the consideration received (7,500,000 shares of common stock of Internet Media Services, Inc. or a 37% interest) and the carrying value of the assets and liabilities sold. Given that the consideration received is not readily measurable because of the lack of activity in Internet Media Services, Inc. prior to the transaction, the Company determined that the value of the "business transferred" is more readily measurable. The Company determined the fair market value of the business transferred based on a discounted cash flow model. Under the equity method investment the Company is required to account for the difference between the cost of an investment and the amount of the underlying equity in net assets of an investee as if the investee were a consolidated subsidiary. If the investor is unable to relate the difference to specific accounts of the investee (*e.g.*, property and equipment), the difference should be considered to be the same as goodwill. Investors shall not amortize goodwill associated with equity method investments after the date ASC 350/Statement No. 142, *Goodwill and Other Intangible Assets*, is initially applied by the entity in its entirety. The Company has determined that given the lack of activity in Internet Media Services, Inc. prior to the transaction, the difference between the cost of the investment (fair market value) and the underlying equity interest is attributable to goodwill which difference amounted to approximately $243,000 at December 31, 2009. For the period from October 9, 2009 through December 31, 2009, the Company's equity in the earnings of Internet Media Services was di minimus and not recorded by the Company. The total assets and liabilities of Internet Media Services, Inc. as of December 31, 2009 amounted to approximately $350,000 and $60,000, respectively. (See Note 8)

***Goodwill*** - Goodwill is the excess of cost of an acquired entity over the fair value of amounts assigned to assets acquired and liabilities assumed in a business combination. Goodwill is not amortized, rather it is tested for impairment annually, and will be tested for impairment between annual tests if an event occurs or circumstances change that would indicate the carrying amount may be impaired. Impairment testing for goodwill is done at a reporting unit level. Reporting units are one level below the business segment level, but are combined when reporting units within the same segment have similar economic characteristics. The Company has three reporting units based on the current structure. An impairment loss generally would be recognized when the carrying amount of the reporting unit's net assets exceeds the estimated fair value of the reporting unit. The Company performs annual assessments and has determined that no impairment is necessary

***Other Intangible Assets, Patent Defense Costs and Patent Application Costs*** – Other intangible assets consists of costs associated with the application, acquisition and defense of the Company's patents, contractual rights to patents and trade secrets associated with the Company's technologies and a customer list obtained as a result of acquisitions. The Company's patents and trade secrets are for document anti-counterfeiting and anti-scanning technologies and processes that form the basis of the Company's document security business. Patent application costs are capitalized and amortized over the estimated useful life of the patent, which generally approximates its legal life. External legal costs incurred to defend the Company's patents are capitalized to the extent of an evident increase in the value of the patents and an expected successful outcome, in accordance to guidance provided by FASB Concept Statement No. 6 and related guidance in AICPA Technical Questions and Answers, Section 2260, Other Assets, paragraph .03, "Legal Expenses Incurred to Defend Patent Infringement Suit". Patent defense costs are expensed at the point when it is determined that the outcome is expected to be unsuccessful. The Company capitalizes the cost of an appeal until it is determined that the appeal will be unsuccessful. The Company's capitalized patent defense costs expenses are analyzed for impairment based on the expected eventual outcome of the legal action and recoverability of proceeds or added economic value of the patent in excess of the costs. Legal actions related to the same patent defense case are unified into one asset group for the purposes on the impairment analysis. Intangible asset amortization expense is classified as an operating expense. The Company believes that the decision to incur patent costs is discretionary as the associated products or services can be sold prior to or during the application process. The Company accounts for other intangible amortization as an operating expense, unless the underlying asset is directly associated with the production or delivery of a product. To date, the amount of related amortization expense for other intangible assets directly attributable to revenue recognized is not material.

***Impairment of Long-Lived Assets -***The Company accounts for long-lived assets and certain identifiable intangibles for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net undiscounted cash flows expected to be generated by the asset including its ultimate disposition. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Fair value is determined based on discounted cash flows or appraised values, depending on the nature of the assets. In December 2008, the Company recorded an impairment $361,000 for a license agreement the Company had acquired in 2006 for which the Company assessed that the probable future cash flows expected to be derived from the license did not support the net carrying value of the license as of December 31, 2008. (See Note 5)

***Fair Value of Financial Instruments*** - Fair value estimates discussed herein are based upon certain market assumptions and pertinent information available to management as of December 31, 2009. The carrying amounts reported in the balance sheet as of December 31, 2009 of cash and cash equivalents, accounts receivable, accounts payable and accrued expenses approximate fair value because of the immediate or short-term maturity of these financial instruments. The fair value of notes payable and long-term debt approximates their carrying value as the stated or discounted rates of the debt reflect recent market conditions.

***Conventional Convertible Debt* -**When the convertible feature of the conventional convertible debt provides for a rate of conversion that is below market value, this feature is characterized as a beneficial conversion feature (“BCF"). Prior to the determination of the BCF, the proceeds from the debt instrument were first allocated between the convertible debt and any detachable free standing instruments that are included, such as common stock warrants. We record a BCF as a debt discount pursuant to ASC Topic 470-20, formerly EITF Issue No. 98-5 (EITF 98-05"), Accounting for Convertible Securities with Beneficial Conversion Features or Contingency Adjustable Conversion Ratio," and EITF Issue No. 00-27, “Application of EITF Issue No. 98-5 to Certain Convertible Instrument(s)". In those circumstances, the convertible debt will be recorded net of the discount related to the BCF. We amortize the discount to interest expense over the life of the debt using the effective interest method.

***Share-Based Payments*** - Compensation cost for stock awards are measured at fair value and recognize compensation expense over the service period for which awards are expected to vest. The Company uses the Black-Scholes option pricing model for determining the estimated fair value for stock-based awards. The Black-Scholes model requires the use of subjective assumptions which determine the fair value of stock-based awards, including the option’s expected term and the price volatility of the underlying stock. For equity instruments issued to consultants and vendors in exchange for goods and services follows the Company determines the measurement date for the fair value of the equity instruments issued at the earlier of (i) the date at which a commitment for performance by the consultant or vendor is reached or (ii) the date at which the consultant or vendor’s performance is complete. In the case of equity instruments issued to consultants, the fair value of the equity instrument is recognized over the term of the consulting agreement.

***Revenue Recognition* -** Sales of security and commercial printing products, and legal products are recognized when a product or service is delivered, shipped or provided to the customer and all material conditions relating to the sale have been substantially performed.

For digital solutions sales, revenue is recognized in accordance with authoritative guidance on software revenue recognition. Accordingly, revenue is recognized when all of the following conditions are satisfied: (1) there is persuasive evidence of an arrangement; (2) the service or product has been provided to the customer; (3) the amount of fees to be paid by the customer is fixed or determinable (4) the collection of our fees is reasonably assured.

The Company recognizes revenue from technology licenses once all the following criteria for revenue recognition have been met: (1) persuasive evidence of an agreement exists; (2) the right and ability to use the product or technology has been rendered; (3) the fee is fixed and determinable and not subject to refund or adjustment; and (4) collection of the amounts due is reasonably assured.

***Advertising Costs*** – Generally consist of online, keyword advertising with Google with additional amounts spent on certain print media in targeted industry publications. Advertising costs were $23,000 in 2009 ($42,000 – 2008).

***Research and Development*** – Research and development costs are expensed as incurred.

***Foreign Currency*-**. Net gains and losses resulting from transactions denominated in foreign currency are recorded as other income or loss.

***Income Taxes*** - The Company recognizes estimated income taxes payable or refundable on income tax returns for the current year and for the estimated future tax effect attributable to temporary differences and carry-forwards. Measurement of deferred income items is based on enacted tax laws including tax rates, with the measurement of deferred income tax assets being reduced by available tax benefits not expected to be realized. We recognize penalties and accrued interest related to unrecognized tax benefits in income tax expense.

***Earnings Per Common Share*** - The Company presents basic and diluted earnings per share. Basic earnings per share reflects the actual weighted average of shares issued and outstanding during the period. Diluted earnings per share are computed including the number of additional shares that would have been outstanding if dilutive potential shares had been issued. In a loss year, the calculation for basic and diluted earnings per share is considered to be the same, as the impact of potential common shares is anti-dilutive.

For the years ended December 31, 2009 and 2008, there were up to 2,652,886 and 1,868,063, respectively, of shares potentially issuable under convertible debt agreements, options, warrants and restricted stock agreements that could potentially dilute basic earnings per share in the future were excluded from the calculation of diluted earnings per share because their inclusion would have been anti-dilutive to the Company's losses in the respective years. From January 1, 2010 to March 19, 2010 , the Company issued a total of 1,277,437 shares of common stock that will dilute future earnings of the Company, consisting of 735,437 shares that were issued in conjunction with the acquisition of Premier Packaging (See Note 16), 304,000 share issued for the exercise of warrants, 200,000 shares issued for private placements, and 38,000 shares issued for payments. In addition, the Company issued 150,000 options to employees during this period that could potentially dilute basic earnings per share in the future.

***Concentration of Credit Risk*** - The Company maintains its cash and cash equivalents in bank deposit accounts, which at times may exceed federally insured limits. The Company believes it is not exposed to any significant credit risk as a result of any non-performance by the financial institutions.

During 2009, two customers accounted for 19% and 12% of the Company's total revenue from continuing operations, respectively. As of December 31, 2009, two customers' account receivable balance accounted for 21% and 17% of the Company's trade accounts receivable balance, respectively. During 2008, two customers accounted for 11% and 10% of the Company's total revenue from continuing operations, respectively. As of December 31, 2008, one customer account receivable balance that was acquired as part of the Company's acquisition of the assets of a commercial printer in December 2008, accounted for 42% of the Company's trade accounts receivable balance. The risk with respect to trade receivables is mitigated by credit evaluations we perform on our customers, the short duration of our payment terms for the significant majority of our customer contracts and by the diversification of our customer base.

***Continuing Operations -*** The Company has incurred significant net losses in previous years. The Company's ability to fund its capital requirements out of its available cash and cash generated from its operations depends on a number of factors. Some of these factors include the Company's ability to (i) increase commercial and security printing and plastic card sales; (ii) increase sales of the Company's digital products; and (iii) integrate its new acquisition of Premier Packaging with its existing product lines. If the Company cannot generate sufficient cash from its operations as of December 31, 2009, the Company has approximately $449,000 in cash and $417,000 available to it under one credit facility. In February 2010, the Company raised approximately $1.1 million through the exercise of warrants and sale of shares of common stock through private placements. The Company used approximately $600,000 of these funds towards the acquisition of Premier Packaging Corp. The remainder is available for working capital requirements together with up to $1,000,000 available under a credit line at its Premier Packaging, subsidiary acquired in 2010. (See Note 16). Further, the Company may need to raise additional funds in the future in order to fund its working capital needs and pursue its growth strategy, which although there can be no assurances, management feels that sources for these additional funds will be available through either current or future investors.

***Recent Accounting Pronouncements***

In December 2007, the Financial Accounting Standards Board ("FASB") issued SFAS 141(r), *Business Combinations*, now Accounting Standards Codification ("ASC") 805, which addresses the accounting and disclosure for identifiable assets acquired, liabilities assumed, and noncontrolling interests in a business combination. In April 2009, the FASB issued FASB Staff Position No. FAS 141(r)-1, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies* (FSP FAS 141(r)-1), which amended certain provisions of SFAS 141(r) related to the recognition, measurement, and disclosure of assets acquired and liabilities assumed in a business combination that arise from contingencies. SFAS 141(r) and FSP FAS 141(r)-1 became effective in the first quarter of 2009, and did not have a material impact on the consolidated financial statements.

In June 2008, the EITF reached a consensus in Issue No. 07-5, "Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock" ("EITF 07-5"), now ASC 815. This Issue addresses the determination of whether an instrument (or an embedded feature) is indexed to an entity's own stock, which is the first part of the scope exception in paragraph 11(a) of SFAS 133. EITF 07-5 is effective for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early application is not permitted. The adoption of EITF 07-5 during the first quarter of 2009 did not have a material impact on the consolidated financial statements.

In May 2009, the FASB issued SFAS No. 165, “Subsequent Events” (“SFAS No. 165”), now ASC 855, to incorporate accounting guidance that originated as auditing standards into the body of authoritative literature issued by the FASB. SFAS No. 165 requires the evaluation of subsequent events through the date the financial statements are issued and the disclosure of the date through which subsequent events were evaluated and the basis for that date. This statement is effective for interim and annual financial periods ending after June 15, 2009. The Company adopted the requirements of SFAS No. 165 for the period ending June 30, 2009. The adoption of SFAS No. 165 did not have a significant impact on our consolidated financial position, results of operations or cash flows. (See Note 16).

*FASB Codification.* In July 2009, the FASB issued SFAS No. 168, “The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles (“GAAP”) (as amended)” (“SFAS No. 168”), now ASC 105, making the FASB Accounting Standards Codification the single source of authoritative nongovernmental U.S. GAAP. The Codification is not intended to change GAAP, however, it will represent a significant change in researching issues and referencing U.S. GAAP in financial statements and accounting policies. This statement is effective for financial statements issued for interim and annual periods ending after September 15, 2009. The Company has adopted the new codification standards.

ASU No. 2010-06, Fair Value Measurements and Disclosures (Topic 820) – Improving Disclosures about Fair Value Measurements This ASU affects all entities that are required to make disclosures about recurring and nonrecurring fair value measurements under FASB ASC Topic 820, originally issued as FASB Statement No. 157, Fair Value Measurements. The ASU requires certain new disclosures and clarifies two existing disclosure requirements. The new disclosures and clarifications of existing disclosures are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. The Company is currently evaluating the potential impact of the adoption on the consolidated financial position, results of operations and cash flows.

**NOTE 3. – INVENTORY**

Inventory consisted of the following:

| | December 31, 2009 | December 31, 2008 |
|---|---|---|
| Finished Goods | $ 38,093 | $ 137,972 |
| Work in process | 58,493 | 120,713 |
| Raw Materials | 87,588 | 100,349 |
| | $ 184,174 | $ 359,034 |

**NOTE 4. - FIXED ASSETS**

Fixed assets consisted of the following at December 31:

| | Estimated Useful Life | 2009 Purchased | 2009 Under Capital Leases | 2008 Purchased | 2008 Under Capital Leases |
|---|---|---|---|---|---|
| Machinery & equipment | 5-7 years | $ 752,387 | $ 547,936 | $ 770,672 | $ 484,936 |
| Leasehold improvements | up to 13 years (1) | 735,434 | - | 727,339 | - |
| Furniture & fixtures | 7 years | 70,209 | 0 | 90,952 | - |
| Software & websites | 3 years | 270,725 | - | 258,744 | - |
| Total cost | | $ 1,828,755 | $ 547,936 | $ 1,847,707 | $ 484,936 |
| Less accumulated depreciation | | 809,082 | 281,383 | 610,267 | 205,019 |
| Net | | $ 1,019,673 | $ 266,553 | $ 1,237,440 | $ 279,917 |

(1) Expiration of lease term

**NOTE 5. - INTANGIBLE ASSETS**

***Goodwill -*** The Company performs an annual fair value test of its recorded goodwill for its reporting units using a discounted cash flow and capitalization of earnings approach. As of December 31, 2009, the Company had goodwill of approximately $1,316,000 attributable to the document security products and printing segment. There was no goodwill recorded by the Company as a result of the acquisition of substantially all of the assets of DPI of Rochester, LLC in December 2008. In October 2009, we sold the assets and liabilities associated with our Legalstore.com business in exchange for common stock of Internet Media Services, Inc.. The sale included goodwill with a net book value of approximately $81,000.

***Other Intangible Assets*** - Other intangible assets are comprised of the following at December 31:

| | Useful Life | 2009 Gross Carrying Amount | 2009 Accumulated Amortizaton | 2009 Net Carrying Amount | 2008 Gross Carrying Amount | 2008 Accumulated Amortizaton | 2008 Net Carrying Amount |
|---|---|---|---|---|---|---|---|
| Royalty rights | 5 years | $ 90,000 | $ 90,000 | $ - | $ 90,000 | $ 90,000 | $ - |
| Acquired intangibles | 5 years | 666,300 | 532,285 | 134,015 | 666,300 | 405,424 | 260,876 |
| Patent acquisition and defense costs | Varied (1) | 4,729,889 | 3,879,341 | 850,548 | 4,729,889 | 2,732,422 | 1,997,467 |
| Patent application costs | Varied (2) | 776,159 | 171,753 | 604,406 | 718,875 | 103,429 | 615,446 |
| | | **$ 6,262,348** | **$ 4,673,379** | **$ 1,588,969** | **$ 6,205,064** | **$ 3,331,275** | **$ 2,873,789** |

(1)- patent rights are amortized over their expected useful life which is generally the legal life of the patent. As of December 31, 2009 the weighted average remaining useful life of these assets in service was 1.1 years.

(2)- patent rights are amortized over their expected useful life which is generally the legal life of the patent. As of December 31, 2009 the weighted average remaining useful life of these assets in service was 13.6 years.

Actual amortization for 2009 and 2008 and expected amortization for each of the next five years is as follows:

| | | |
|---|---|---|
| 2008 Actual | | $1,972,000 |
| 2009 Actual | | $1,342,000 |
| | | |
| Expected | 2010 | $ 641,185 |
| | 2011 | 426,781 |
| | 2012 | 39,845 |
| | 2013 | 39,845 |
| | 2014 | 39,845 |
| | Thereafter | 401,468 |
| | | $1,588,969 |

*Acquired Intangible Assets -* In February 2006, the Company acquired intangible assets associated with its acquisitions of the assets of Plastic Printing Professional. These intangible assets were valued at $625,000 by an independent valuation firm and consist of customer lists, trade name and brand, and a non-compete agreement.

In June 2007, the Company entered into an agreement with International Barcode Technologies, also known as BTI, to extend the expiration date of warrants to purchase 500,000 shares of common stock of the Company at a purchase price of $10.00 per share from June 16, 2007 to December 31, 2007. In exchange, BTI agreed to provide the Company with a five year non-exclusive license to market and produce BTI's advanced barcode technologies in the United States. The value of the extension of the warrant was determined to be approximately $521,000 using the Black-Scholes option pricing model. This amount was recorded as an other intangible asset and was being amortized over the expected useful life of the license agreement of five years. In December 2008, the Company recorded an impairment of $361,000 when the Company assessed that the probable future cash flows expected to be derived from the license did not support the net carrying value of the license as of December 31, 2008.

*Patent Acquisition and Defense Costs* **-** Included in the Company's capitalized patent defense costs are costs associated with the acquisition of certain rights associated with patents that the Company is defending. In December 2004, the Company entered into an agreement with the Wicker Family in which Document Security Systems obtained the legal ownership of technology (including patent ownership rights) previously held by the Wicker Family. At that time, the agreement with the Wicker Family provided that the Company would retain 70% of the future economic benefit derived from settlements, licenses or subsequent business arrangements from any infringer of the Wicker patents that Document Security Systems chooses to pursue. The Wicker Family was to receive the remaining 30% of such economic benefit. In February 2005, the Company further consolidated its ownership of the Wicker Family based patents and its rights to the economic benefit of infringement settlements when the Company purchased economic interests and legal ownership from approximately 45 persons and entities that had purchased various rights in Wicker Family technologies over several decades. The Company issued an aggregate of 541,460 shares of its Common Stock for the rights of the interest holders and secured 100% ownership of a US Patent and approximately 16% of additional economic rights to settlements with infringers of the Wicker Family's foreign patents. The value of the shares of Common Stock was determined based upon the closing price of the shares of the Company's Common Stock on the American Stock Exchange on February 15, 2005 of $7.25 per share was, $ 3,905,672 net of expenses. As of December 31, 2009, the net unamortized balance of acquired patent assets was $757,000.

Patent defense costs are comprised of legal cost associated with our patent infringement suit against the European Central Bank ("ECB Litigation"). We based our decision to defer the costs associated with this case on the principal that successful patent defense costs are capitalizable. First, the Company's case is based on the relationship of the inventor of the Company's patent with various representatives of European currency printers, consultants, and other participants during the late 1990's in regard to the industry's attempts to defeat new advanced levels of copier and scanning technologies that were then emerging in the marketplace. The inventor of the DSS's patent had a proven history of success in anti-counterfeiting technology, and was seen as a source for these industry participants to help solve these challenges. The Company believes that it can establish a direct link between these communications and the use of the technology by these industry participants in the design and production of the Euro, which was designed in the late 1990's and was initially released for circulation in 2002. In addition, prior to filing the ECB litigation, the Company consulted extensively with legal counsel and performed extensive due diligence with our legal counsel for approximately one year to analyze the merits of our patent infringement case, and only after these efforts did we take our legal counsel's recommendation to proceed with the European Central Bank (ECB) Litigation. Based on the cumulative evidence available to the Company at the time of filing the suit, the Company has believed from the outset of the case that it will be able to prove in court that the ECB infringed the Company's patent on its Euro notes by using the Company's technology in the design of the notes for the specific purpose of making the notes difficult to copy, and therefore the Company's infringement case would be successful. Since the case was filed, the Company has not seen any evidence from the ECB which specifically addresses the Company's infringement assertions.

The most significant events in the case since it was filed have been the challenges of patent validity by the ECB. The Company believes that the ECB's challenge of patent validity represents the biggest hurdle to a successful outcome. To date, there have been four adverse rulings and two positive rulings in regard to the patent's validity. The Company believes that the European court system for patent disputes is unique since it separates jurisdiction to its member states despite having a unified patent application and approval system. As a case in point, on March 26, 2007, the Company's patent was deemed invalid in the United Kingdom and then on the immediately following day, on March 27, 2007, the Company's patent was ruled as valid in Germany. In addition, on January 9, 2008 the French Court held that the patent was invalid in France for the same reasons given by the English Court. On March 12, 2008 the Dutch Court, having considered the English, German and French decisions, ruled that the Patent is valid in the Netherlands. On November 3, 2009, the Belgium Court held that the Patent was invalid in Belgium for the same reasons given by the English and French Courts.

When we assess the impact of these decisions, the Company understands that the adverse rulings on validity mean that the Company will not be able to file infringement lawsuits in those jurisdictions, and assesses these material changes in its analysis of the potential proceeds of its case. The win in Germany, which has the largest volume of circulation of the European banknotes, had a significant positive impact on the Company's probability analysis of cash flows associated with the case. Furthermore, the Company understands that a successful infringement ruling in any one of the jurisdictions of the European Union will have a similar impact as if the Company was successful in all of the jurisdictions of the case, since the ECB would have to either remove the technology from its banknotes, produce different banknotes depending on the jurisdiction in which the banknote is circulated, or pay a licensing fee to continue to use the Company's patented technology. The Company believes that the ECB would address the going-forward use of the Company's technology in its banknotes, either through a license or settlement, regardless if the Company wins in one jurisdiction or all nine. Furthermore, regardless of the ECB's decision on how to address a going-forward usage of the Company's technology, if the Company is successful in its litigation against the ECB, it is expected that a court would impose damages on the ECB for prior, unauthorized usage of the Company's patent.

The Company will seek a lump-sum payment for all past uses of the infringed patented technology, and then will seek an on-going license fee for the continued use of the patented technology. The Company expects that the ECB will choose to pay the ongoing license fees rather than redesign the Euro bank notes to not include the patented technology. The Company's basis for this expectation is based on its understanding of the security printing business. The Company has a long history of licensing its other patented technology to commercial security printers for use in commercial and governmental documents in the same manner (% of sales) that it expects the ECB to pay, either via court decision or a license fee settlement.

In its analysis of the recoverability of its capitalized patent defense costs, the Company uses the potential proceeds from its ECB Litigation as the primary source of future cash flows. In addition, the Company believes that there are additional infringers of the technology that it may pursue in the future, depending on the outcomes of its suit with the ECB. Specifically, the Company uses assumptions of banknote production volumes during the alleged infringement period and estimated banknote production costs from third party sources to determine the estimated total costs of the production of the Euro banknotes in each year of infringement. The Company then applies a royalty rate that the Company generally charges international licensees and that the Company believes is consistent with industry standards to determine the amount that would be due to the Company if the ECB had licensed the technology from the Company on the Company's standard licensing terms. The Company uses this amount as an estimate of the gross proceeds it could receive from a successful outcome of the litigation in all jurisdictions. The Company then allocates these potential proceeds by the percent of circulation of each jurisdiction in which the Company has ongoing litigation to determine the potential proceeds of a successful outcome in the jurisdictions where the patent has been held as valid or where the patent validity has not yet been determined. Finally, the Company uses a probability factor in its analysis that discounts these potential future proceeds that takes into account the different status levels of each jurisdiction. Thus, the Company determines a probability based cash flow which is compared to the net patent defense costs balance to determine whether an impairment of these costs has occurred.

If a patent is determined to be invalid in a jurisdiction, as has occurred in the United Kingdom, France, Belgium and Austria, then all appeal costs and other costs associated with the loss such as court and opposition fees awarded are expensed as incurred in the period in which the amount is determined.

On March 19, 2008, the Company received notification that its appeal of the invalidation of its European Paten 455750B1 in the UK was not successful. As a result of the adverse court decision, the Company recognized an impairment loss of $292,000 during 2008 associated with the costs directly related to the UK appeal. The impairment loss includes a judgment for reimbursement of estimated counterpart legal fees. In January 2009, the Company received a formal request for the fee reimbursement from the ECB of $420,000 in addition to the amounts already paid by the Company. The Company hired an independent firm to assist the Company in reducing or eliminating the ECB's fees request, however, the Company recorded $145,000 as additional accrued expenses and an impairment loss as of December 31, 2008. On July 31, 2009, the UK court made the final assessment of costs for the UK patent validity case due from the Company to the ECB of ₤356,490, of which the Company has paid ₤332,000 through December 31, 2009 and owes approximately ₤25,000 ($40,000 as of December 31, 2009), which amount was included in accrued expenses as of December 31, 2009.

On August 20, 2008, the Company entered into an agreement with Trebuchet Capital Partners, LLC ("Trebuchet") under which Trebuchet has agreed to pay substantially all of the litigation costs associated with pending validity proceedings initiated by the European Central Bank ("ECB") in eight European countries relating to the Company's European Patent 0 455 750B1 that the Company has claimed the ECB infringed in printing of the Euro currency (the "Patent"). Trebuchet also agreed to pay substantially all of the litigation costs associated with future validity challenges filed by the ECB or other parties, provided that Trebuchet elects to assume the defense of any such challenges, in its sole discretion, and patent infringement suits filed against the ECB and certain other alleged infringers of the Patent, all of which suits may be brought at the sole discretion of Trebuchet and may be in the name of the Company, Trebuchet or both. The Company provided Trebuchet with the sole and exclusive right to manage infringement litigation relating to the Patent in Europe, including the right to initiate litigation in the name of the Company, Trebuchet or both and to choose whom and where to sue, subject to certain limitations set forth in the agreement. Under the terms of the Agreement, the Company and Trebuchet have agreed to equally share all proceeds generated from litigation relating to the Patent, including judgments and licenses or other arrangements entered into in settlement of any such litigation. Trebuchet is also entitled to recoup any litigation expenses specifically awarded to the Company in such actions. Under the terms of the Agreement, and in consideration for Trebuchet's funding obligations, the Company assigned and transferred a 49% interest of the Company's rights, title and interest in the Patent to Trebuchet which allows Trebuchet to have a separate and distinct interest in and share of the Patent, along with the right to sue and recover in litigation, settlement or otherwise to collect royalties or other payments under or on account of the Patent. Trebuchet will receive 50% of all proceeds from any judgments, settlements, licenses or other forms of payment received as a result of any litigation. Pursuant to this transaction, the Company recognized a loss on the sale of patent assets for its assignment and transfer of 49% of its ownership rights in the patent, which had a net book value of approximately $1,670,000, for proceeds of $500,000, As a result, the Company recognized a loss on sale of patent assets of approximately $1,170,000 as of December 31, 2008.

As of December 31, 2009, the net unamortized balance of the Company's capitalized patent defense costs was approximately $93,000.

*Patent Application Costs* **-** On an ongoing basis, the Company submits formal and provisional patent applications with the United States, Canada and countries included in the Patent Cooperation Treaty (PCT). The Company capitalizes these costs and amortizes them over the patents' estimated useful life.

**NOTE 6. – SHORT TERM AND LONG TERM DEBT**

**Long Term Revolving Notes- Related Parties-**On January 4, 2008, the Company entered into a Credit Facility Agreement with Fagenson and Co., Inc., as agent, a related party to Robert B. Fagenson, the Chairman of the Company's Board of Directors. Under the Fagenson Credit Agreement, the Company could borrow up to a maximum of $3,000,000 from time to time up to and until January 4, 2010. Any amount borrowed by the Company pursuant to the Fagenson Credit Agreement has annual interest rate of 2% above LIBOR and is secured by the Common Stock of Plastic Printing Professionals, Inc., ("P3") the Company's wholly owned subsidiary. Interest is payable quarterly in arrears and the principal is payable in full at the end of the term under the Fagenson Credit Agreement. On December 11, 2009, the Company entered into a Letter Agreement with the lenders for the conversion of $2,000,000 of debt owed under the Credit Facility into 1,250,000 shares of Document Security Systems Common Stock. In addition, the parties amended the Credit Facility to allow for a maximum borrowing of up to $1,000,000 and extended the due date to January 4, 2012. As of December 31, 2009, the Company had outstanding $583,000 under the Fagenson Credit Agreement. Under the terms of the agreement the Company is required to comply with various covenants. As of December 31, 2009, the Company was in default of the agreement due to a failure to pay interest when due. Fagenson and Co. has waived the defaults through January 1, 2011.

On January 4, 2008, the Company also entered into a Credit Facility Agreement with Patrick White, the Company's Chief Executive Officer and a member of the Board of Directors. Under the White Credit Agreement, the Company could borrow up to $600,000 from time to time up to and until January 4, 2010. Any amount borrowed by the Company pursuant to the White Credit Agreement will have an annual interest rate of 2% above LIBOR. On December 30, 2009, the Company used the proceeds from a $450,000 Convertible Note to pay in full the $450,000 due under the White Credit Agreement.

Interest expense for the two revolving notes for the years ended December 31, 2009 and 2008 was $106,000 and $82,000, respectively, of which $152,000 for the Fagenson and Company Note is included in accrued expenses as of December 31, 2009 ($54,000 -2008).

**Notes Payable-** On May 7, 2008 the Company entered into a $500,000 unsecured credit facility with Taiko III Corp to fund the Company's ongoing patent infringement and related lawsuits against the European Central Bank. Interest accrued on the unpaid principal amount at a 6% annual rate. On August 20, 2008, the Company entered into an agreement with Trebuchet Capital Partners, LLC, which, among other things, called for Trebuchet to pay the Company $500,000, which the Company used to pay in full the Company's existing obligation owed to Taiko III Corp.

On December 18, 2008, the Company's wholly owned subsidiary, Secuprint, Inc. (dba DPI Secuprint, Inc.) entered a Secured Promissory Note with Baum Capital Investments Inc. in the principal amount of up to $900,000 to pay for most of the cash portion of the purchase price of the Company's acquisition of substantially all of the assets of DPI of Rochester, LLC. The Secured Promissory Note had a one-year term, and was secured by all of the assets of DPI Secuprint with an annual interest rate of 15% that was reduced to 12% after certain conditions were met. In conjunction with the Note, the Company issued warrants to purchase up to a total of 250,000 shares of the Company's common stock at an average price of $2.00 per share. The warrants are exercisable on February 16, 2009 and expire on December 17, 2013. The fair value of the warrants of approximately $256,000 was determined using the Black Scholes option pricing model, and was recorded as discount on debt and will be amortized over the term of the Note.

On December 9, 2009, the Company used the proceeds from a $350,000 Convertible Note and a $575,000 Promissory Note, respectively, to pay in full the $900,000 Baum Note. The $350,000 Convertible Note matures November 24, 2012, accrues interest at 10%, payable quarterly, and is convertible into up to 218,750 shares of Document Security Systems Common Stock. The $575,000 Promissory Note matures November 24, 2012 and accrues interest at 10%, payable quarterly. Both Notes are secured with equal rights by the assets of the Company's wholly owned subsidiary, DPI Secuprint. In conjunction with the convertible note, the Company determined a beneficial conversion feature existed amounting to approximately $94,000 which was recorded as discount on debt and will be amortized over the term of the Note.

On December 30, 2009, the Company used the proceeds from a $450,000 Convertible Note to pay in full $450,000 due under White Credit Facility. The $450,000 Convertible Note matures June 23, 2012, accrues interest at 8%, payable quarterly, is convertible into up to 260,116 shares of Document Security Systems Common Stock, and is secured by the accounts receivable of the Company, excluding the accounts receivable of the Company's wholly owned subsidiaries, Plastic Printing Professionals and DPI Secuprint. In conjunction with the Note, the Company issued to the holders of the Note warrants to purchase up to 65,000 shares of the Company's common stock within five years at $2.00 per share. The estimated fair market value of these warrants was determined using the Black Scholes option pricing model at approximately $72,000, which was recorded as discount on debt and will be amortized over the term of the Note. Furthermore, in conjunction with this convertible note, the Company determined a beneficial conversion feature existed amounting to approximately $257,000, which was recorded as discount on debt and will be amortized over the term of the Note. In addition, the Company recorded expense of approximately $110,000 for the fair value of 40,000 warrants to purchase the shares of the Company's common stock at $2.00 issuable to the holder of the Convertible Note as a result of the Company's failure to file a registration statement under the terms of the Note.

All of the obligations outstanding as of December 31, 2009 mature during 2012.

**NOTE 7. - STOCKHOLDERS' EQUITY**

***Stock Issued in Private Placements*** -In June, 2008 the Company entered into two Share Purchase Agreements pursuant to which the Company agreed to sell a total of 500,000 shares of the Company's common stock for an aggregate purchase price of $2,000,000. Pursuant to the terms of the first Agreement, the Company sold 150,000 shares of Common Stock to the Purchaser for $600,000 payable on June 25, 2008. Pursuant to the terms of the first Agreement, the Purchaser could not sell the 150,000 shares of Common Stock purchased thereunder earlier than June 25, 2009. Pursuant to the terms of the second Agreement, the Company sold 350,000 shares of Common Stock for $1,400,000, with $100,000 payable on June 25, 2008 and the remaining $1,300,000 payable in six-month installments over a two-year period. On June 3, 2009, the Company and the purchaser executed a letter agreement terminating the parties' Share Purchase Agreement dated June 25, 2008 and any obligations outstanding thereunder. The first installment of $100,000 was paid. A second payment installment in the amount of $300,000 was due on December 25, 2008, but was not paid. As a result, the parties agreed to terminate the Share Purchase Agreement which resulted in the cancellation of 325,000 of the Company's shares as of June 3, 2009.

On August 20, 2008, the Company entered into an agreement with Trebuchet Capital Partners, LLC who agreed to pay substantially all of the litigation costs associated with pending validity proceedings initiated by the ECB in eight European countries relating to the Company's European Patent 0 455 750B1 that the Company has claimed the ECB infringed in printing of the Euro currency. Trebuchet has also purchased 100,000 shares of the Company's common stock for an aggregate purchase price of $400,000, the proceeds of which were used by the Company to pay existing litigation cost.

Between May 29, 2009 and June 22, 2009, the Company sold 56 investment units in a private placement at a price of $10,000 per unit for aggregate proceeds of $560,000 less $44,000 in expenses, consisting of 400,000 shares of common stock and warrants to purchase an aggregate of 80,000 shares of common stock. The estimated fair market value of these warrants was determined using the Black Scholes option pricing model at approximately $80,000. On July 15, 2009, the Company sold 24.5 investment units for $10,000 per unit for gross cash proceeds of $245,000, consisting of 175,000 shares of Common Stock and Warrants to purchase an aggregate of 35,000 shares of Common Stock. The estimated fair market value of these warrants was determined using the Black Scholes option pricing model at approximately $34,000. On August 24, 2009, the Company completed the sale of 7 investment units in a private placement pursuant to subscription agreements with one accredited investor dated the same date. In the transaction, the Company sold 7 investment units for $10,000 per unit for gross cash proceeds of $70,000, consisting of 50,000 shares of common stock and warrants to purchase an aggregate of 10,000 shares of common stock. The estimated fair market value of these warrants was determined using the Black Scholes option pricing model at approximately $10,000. Each investment unit consisted of 7,142 shares of its common stock and five-year warrants to purchase up to an aggregate of 1,427 shares of its common stock at an exercise price of $2.00 per share.

On September 4, 2009, the Company completed the sale of 44 investment units in a private placement pursuant to subscription agreements with three accredited investors dated the same date. Each investment unit is comprised of 6,250 shares of the Company's common stock and five year warrants to purchase 1,250 shares of common stock at an exercise price of $2.00 per share. In the transaction, the Company sold 44 investment units for $10,000 per unit for gross cash proceeds of $440,000, less expenses of $52,000, consisting of 275,000 shares of common stock and warrants to purchase an aggregate of 55,000 shares of common stock. The estimated fair market value of these warrants was determined using the Black Scholes option pricing model at approximately $54,000.

On October 19, 2009, the Company completed the sale of 17.6 investment units in a private placement pursuant to subscription agreements with three accredited investors dated the same date. Each investment unit is comprised of 6,250 shares of the Company's common stock and five year warrants to purchase 1,250 shares of common stock at an exercise price of $2.00 per share. In the transaction, the Company sold 17.6 investment units for $10,000 per unit for gross cash proceeds of $176,000, less expenses of $17,600, consisting of 110,000 shares of common stock and warrants to purchase an aggregate of 22,000 shares of common stock. The estimated fair market value of these warrants was determined using the Black Scholes option pricing model at approximately $38,000.

***Stock Warrants*** - During 2009, in conjunction with the private placements described above, the Company issued an aggregate of 202,000 warrants to purchase the Company's shares of Common Stock at an exercise price of $2.00, as described above. In addition, during 2009, the Company issued to the holders of a Convertible Note warrants to purchase up to 65,000 shares of the Company's common stock within five years at $2.00 per share.

On October 21, 2009, the Company entered into a consulting agreement with Vertical Innovations and agreed to issue the consultant five year warrants to purchase 50,000 shares of the Company's common stock at $3.00, 100,000 shares of common stock at $3.50 and 50,000 shares of common stock at $4.00. The Company estimated the value of these warrants at approximately $258,000 as of December 31, 2009 using the Black-Scholes option pricing model which the Company expects to record the measurement date fair value as expense over a two year period.

On November 19, 2009, the Company entered into an agreement with Baum Capital for which Baum Capital would execute up to an aggregate amount of $275,000 of Letters of Credit on behalf of the Company's subsidiary, DPI Secuprint, for the extension of credit from certain of DPI Secuprint's paper vendors. The Letters of Credit will have a term of twelve months and are secured by the accounts receivable of DPI Secuprint. In exchange, the Company issued to Baum Capital warrants to purchase 50,000 shares of the Company's common stock at $2.00. The Company valued these warrants at approximately $56,000 using the Black-Scholes option pricing model which the Company expects to record as expense over a one year period.

On December 7, 2009, the Company reached an agreement to issue 40,000 shares of common stock and 50,000 of common stock warrants for the purchase of common shares at $3.00 per share for a period of three years from November 23, 2009, in connection with the settlement of certain litigation between the Company and the recipients. The value of the stock amounted to $85,000 based on the closing price the day the agreement was reached. The fair value of the warrants of approximately $29,500 was determined utilizing the Black Scholes pricing model. The aggregate cost of approximately $115,000 is recognized in the statement of operations under Litigation Settlements,

During year ended December 31, 2008, the Company received $100,000 in proceeds from the exercise of warrants to purchase 50,000 shares of its common stock. The Company received no proceeds from the exercise of warrants during 2009.

On December 18, 2008, the Company issued warrants to purchase up to a total of 250,000 shares of the Company's common stock at an average price of $2.00 per share in conjunction with a secured promissory note. (See Note 6- Short Term and Long-Term Debt) The warrants are exercisable on February 16, 2009 and expire on December 17, 2013. The fair value of the warrants of approximately $256,000 was determined using the Black Scholes option pricing model, and was recorded as discount on debt and will be amortized over the term of the note.

The following is a summary with respect to warrants outstanding and exercisable at December 31, 2009 and 2008 and activity during the years then ended:

| | 2009 | | 2008 | |
|---|---|---|---|---|
| | Warrants | Weighted Average Exercise Price | Warrants | Weighted Average Exercise Price |
| Outstanding January 1 | 761,032 | $ 8.73 | 591,093 | $ 10.82 |
| Granted during the year | 556,988 | $ 2.63 | 250,000 | $ 2.00 |
| Exercised | - | $ - | (50,000) | $ (2.00) |
| Lapsed | - | $ - | (30,061) | $ (5.00) |
| Outstanding at December 31 | 1,318,020 | $ 6.15 | 761,032 | $ 8.73 |
| Exercisable at December 31 | 1,118,020 | $ 6.63 | 761,032 | $ 8.73 |
| Weighted average months remaining | | 43.0 | | 44.7 |

***Stock Options*** - The Company has two stock-based compensation plans. The 2004 Employees' Stock Option Plan (the "2004 Plan") provides for the issuance of up to a total of 1,700,000 shares of common stock authorized to be issued for grants of options, restricted stock and other forms of equity to employees and consultants. Under the terms of the 2004 Plan, options granted thereunder may be designated as options which qualify for incentive stock option treatment ("ISOs") under Section 422A of the Internal Revenue Code, or options which do not qualify ("NQSOs"). The exercise price for options granted under the Director Plan is 100% of the fair market value of the Common Stock on the date of grant. The Non-Executive Director Stock Option Plan (the "Director Plan") provides for the issuance of up to a total of 200,000 shares of common stock authorized to be issued for options grants for non-executive directors and advisors. Under the terms of the Director Plan, an option to purchase (a) 5,000 shares of our common stock shall be granted to each non-executive director upon joining the Board of Directors and (b) 5,000 shares of our common stock plus an additional 1,000 shares of our common stock for each year that the applicable director has served on the Board of Directors, up to a maximum of 10,000 shares per year shall be granted to each non-executive director thereafter on January 2nd of each year; provided that any non-executive director who has not served as a director for the entire year immediately prior to January 2nd shall receive a pro rata number of options based on the time the director has served in such capacity during the previous year. Both Plans were adopted by the Company's shareholders.

The following is a summary with respect to options outstanding at December 31, 2009 and 2008 and activity during the years then ended:

| | 2004 Employee Plan | | | Non-Executive Director Plan | | |
|---|---|---|---|---|---|---|
| | Number of Options | Weighted Average Exercise Price | Weighted Average Life Remaining | Number of Options | Weighted Average Exercise Price | Weighted Average Life Remaining |
| | | | (in years) | | | (in years) |
| Outstanding at December 31, 2007 | 617,500 | 9.70 | | 78,750 | $ 8.78 | |
| Granted | 83,000 | 5.01 | | 37,000 | 6.31 | |
| Exercised | - | - | | - | - | |
| Forfeited | (37,000) | (8.87) | | - | - | |
| Outstanding at December 31, 2008: | 663,500 | 7.27 | | 115,750 | 7.99 | |
| Granted | 274,000 | 4.00 | | 40,000 | 1.86 | |
| Exercised | - | - | | | | |
| Forfeited | (298,500) | (6.37) | | (23,750) | (4.59) | |
| Outstanding at December 31, 2009: | 639,000 | 6.29 | 2.8 | 132,000 | 6.74 | 2.5 |
| Exercisable at December 31, 2009: | 336,833 | 8.16 | 1.4 | 92,000 | 8.86 | 1.9 |
| | | | | | | |
| Aggregate Intrinsic Value of outstanding options at December 31, 2009 | $ - | | | $ 23,600 | | |
| Aggregate Intrinsic Value of exercisable options at December 31, 2009 | $ - | | | $ - | | |

The weighted-average grant date fair value of options granted during the year ended December 31, 2009 was $0.53 ($2.03 - 2008). There were no options exercised during the year ended December 31, 2009 or 2008.

The fair value of each option award is estimated on the date of grant utilizing the Black Scholes Option Pricing Model that uses the assumptions noted in the following table.

| | 2009 | 2008 |
|---|---|---|
| Volatility | 54.7 % | 53.6 % |
| Expected option term | 3.9 years | 3.3 years |
| Risk-free interest rate | 2.30 % | 3.09 % |
| Expected forfeiture rate | 0.0 % | 0.0 % |
| Expected dividend yield | 0.0 % | 0.0 % |

***Restricted Stock Issued to Employees***– Restricted common stock is issued under the 2004 Plan for services to be rendered and may not be sold, transferred or pledged for such period as determined by our Compensation Committee. Restricted stock compensation cost is measured as the stock's fair value based on the quoted market price at the date of grant. The restricted shares issued reduce the amount available under the employee stock option plans. Compensation cost is recognized only on restricted shares that will ultimately vest. The Company estimates the number of shares that will ultimately vest at each grant date based on historical experience and adjust compensation cost and the carrying amount of unearned compensation based on changes in those estimates over time. Restricted stock compensation cost is recognized ratably over the requisite service period which approximates the vesting period. An employee may not sell or otherwise transfer unvested shares and, in the event that employment is terminated prior to the end of the vesting period, any unvested shares are surrendered to us. We have no obligation to repurchase any restricted stock.

The following is a summary of activity of restricted stock during the years ended at December 31, 2009 and 2008:

| | Shares | Weighted- average Grant Date Fair Value |
|---|---|---|
| Restricted shares outstanding, December 31, 2007 | 513,323 | $ 12.35 |
| Restricted shares granted | 110,592 | 2.31 |
| Restricted shares vested | (46,134) | (10.49) |
| Restricted shares forfeited | (250,000) | (12.50) |
| Restricted shares outstanding, December 31, 2008 | 327,781 | $ 9.05 |
| Restricted shares granted | - | - |
| Restricted shares vested | (30,281) | (6.77) |
| Restricted shares forfeited | (212,500) | (10.05) |
| Restricted shares outstanding, December 31, 2009 | 85,000 | $ 7.61 |

As of December 31, 2009, there are 40,000 unvested restricted shares granted to an employee that vests proratably through December 2013 and 45,000 restricted shares that will vest only upon the occurrence of certain through December 2014 which include, among other things a change of control of the Company or other merger or acquisition of the Company, the achievement of certain financial goals, including among other things a successful result of the Company's patent infringement lawsuit against the European Central Bank. These 45,000 shares, if vested, would result in the recording of stock based compensation expense of approximately $562,500, the grant date fair value, over the period beginning when any of the contingent vesting events is deemed to be probable over the expected requisite service period. As of December 31, 2009, vesting is not considered probable and no compensation expense has been recognized related to the performance grants.

On May 10, 2008, the Company accelerated the vesting of 33,333 restricted shares and retired 250,000 of unvested restricted stock as the result of a separation agreement with the Company's former President. The 33,333 shares of restricted stock, formerly set to vest pro-ratably through June 2009, were accelerated to vest pro-ratably on a monthly basis over a ten-month vesting period ending in March 2009. As a result of the acceleration of the 33,333 shares of restricted stock, the Company recognized approximately $194,000 of stock based compensation during the year ended December 31, 2008. (See Note 13) On December 18, 2008, the Company issued under the 2004 Plan 50,000 restricted shares of the Company's common stock each to two former employees of DPI of Rochester, LLC, which the Company acquired substantially all of the assets of on that date. The restricted shares had an aggregated grant date fair value of $210,000 and will vest proratably over five years.

***Stock-Based Compensation* –**Stock-based compensation includes expense charges for all stock-based awards to employees, directors and consultants. Such awards include option grants, warrant grants, and restricted stock awards. During the year ended December 31, 2009, the Company had stock compensation expense of approximately $292,000 or $0.02 per share ($1,747,000- 2008; $0.12 per share). As of December 31, 2009, there was approximately $550,000 of total unrecognized compensation costs (excluding the $563,000 that vest upon the occurrence of certain events) related to non-vested options and restricted stock granted under the Company's stock option plans which the Company expects to vest over a period of not to exceed five years.

On August 13, 2008, the Company cancelled 330,500 employee stock options with exercise prices ranging from $6.24 to $12.50, and replaced the cancelled options with 330,500 employee stock options with an exercise price of $6.00. No other terms of the options were modified. On the date of grant, the fair market value of the Company's Common Stock was $5.15. The repricing was treated as a modification under FAS123R, and resulted in an additional aggregate fair value expense determined using the Black- Scholes option pricing model of approximately $225,000, of which approximately $170,000 was expensed as of the grant date for fully vested options. The remaining fair value of the modified options is being expensed proratably during the expected vesting period of the options thru 2010.

**NOTE 8. –DECONSOLIDATION OF LEGALSTORE.COM DIVISION**

On October 8, 2009, the Company entered into an Asset Purchase Agreement with Internet Media Services, Inc. (IMS) whereby the Company sold the assets and liabilities of Legalstore.com, a division of the Company with assets of approximately $252,000 and liabilities of $13,000, in exchange for 7,500,000 shares of common stock of the Internet Media Services, Inc. The Company recorded its investment in Internet Media Services as an equity method investment at the fair market value of the business sold. Management determined that the transaction did not qualify as a non-monetary exchange due to the exception noted in ASC 845-10 (A transfer of assets to an entity in exchange for an equity interest in that entity). Management determined that the transaction qualified as a derecoginition of a subsidiary under ASC 810-10-40. Therefore, the Company accounted for the deconsolidation of a subsidiary ("the business") by recording the consideration received at fair market value and recognizing a gain in net income measured as the difference between: the fair value of the consideration received (7,500,000 shares of common stock of Internet Media Services, Inc. or a 37% interest) and the carrying value of the assets and liabilities sold. Given that the consideration received is not readily measurable because of the lack of activity in Internet Media Services, Inc. prior to the transaction, the Company determined that the value of the "business transferred" is more readily measurable. The Company determined the fair market value of the business transferred based on a discounted cash flow model amounted to $350,000, which resulted in a gain after transaction expenses of approximately $26,000 which is included in the consolidated statement of operations. The Company is recording the equity method investment at fair value. Under the equity method investment the Company is required to account for the difference between the cost of an investment and the amount of the underlying equity in net assets of an investee as if the investee were a consolidated subsidiary. If the investor is unable to relate the difference to specific accounts of the investee (*e.g.*, property and equipment), the difference should be considered to be the same as goodwill. Investors shall not amortize goodwill associated with equity method investments after the date ASC 350/Statement No. 142, *Goodwill and Other Intangible Assets*, is initially applied by the entity in its entirety. The Company has determined that given the lack of activity in Internet Media Services, Inc. prior to the transaction, the difference between the cost of the investment (fair market value) and the underlying equity interest is attributable to goodwill. The Company is continuing to report the activity in operating loss and not breaking out and reporting it as discontinued operations because the operations and cash flows of the component have not been eliminated from the ongoing operations of the entity as a result of the equity method investment and because the Company will have significant continuing involvement in the operations of Internet Media Services, Inc. after the disposal transaction because of the ownership percentage and the board representation.

In conjunction with the Asset Purchase Agreement, the Company and Internet Media Services made the followg agreements:

Within 180 days of closing, IMS will file a registration statement on Form S-1 with respect to the IMS Common Stock pursuant to the terms of the Asset Purchase Agreement and Registration Rights Agreement (the "Registration Rights Agreement") executed by IMS and the Company concurrently with the Asset Purchase Agreement. Pursuant to the terms of the Asset Purchase Agreement, Registration Rights Agreement, and the Stock Pledge and Escrow Agreements executed by IMS' principal shareholders, IMS, Lester Levin, Inc. and the Company (the "Pledge Agreements"), if IMS fails to secure registration of at least 20% of the IMS Common Stock within 360 days of closing, and to meet certain working capital thresholds contained in the Asset Purchase Agreement, then IMS will be in default. In the event of a default by IMS with respect to the registration of the IMS Common Stock, if IMS has failed to satisfy the working capital requirements provided for in the Asset Purchase Agreement, the Company may take back the collateral, consisting of 12,500,000 shares (an additional 61% of the IMS shares outstanding) of IMS Common Stock owned by the IMS shareholders identified in the Pledge Agreements. If IMS is in default with respect to the registration of IMS Common Stock, and IMS has satisfied the working capital requirements contained in the Asset Purchase Agreement, the Company may take back the collateral, consisting of 5,250,000 shares (an additional 26% of IMS shares outstanding) of IMS Common Stock owned by the IMS shareholders identified in the Pledge Agreements. In addition to the Asset Purchase Agreement, the Registration Rights Agreement, and the Pledge Agreements, IMS' principal shareholders, IMS and the Company entered into a voting agreement (the "Voting Agreement") whereby the principal shareholders of IMS agreed to vote all IMS Common Stock held by them so as to elect two nominees designated by Lester Levin, Inc. or the Company as members of the IMS Board of Directors.

**NOTE 9. –BUSINESS COMBINATIONS-**

On December 18, 2008, the Company" through its wholly owned subsidiary, Secuprint, Inc. (dba DPI Secuprint, Inc.) acquired substantially all of the assets of DPI of Rochester, LLC ("DPI") for approximately $938,000 in cash and $145,000 of expenses, the right to assume certain leases, including the lease on its building, and a contingent payment of up to $50,000 within five years of the acquisition. The acquisition has been accounted for as a business combination. Under business combination accounting (formerly SFAS141), the total purchase price was allocated to DPI's net tangible and identifiable intangible assets, if any, based on their estimated fair values as of December 18, 2008 as determined by management. No goodwill was recorded as a result of the business combination. The contingent payment of up to $50,000 was considered remote, therefore, future payments made, if any, will be considered additional purchase price when paid.

The allocation of the purchase price and the estimated useful lives associated with the acquired assets is as follows:

| | Amount | Estimated Useful Life |
|---|---|---|
| Accounts receivable | $ 876,287 | |
| Inventory and work in process | 67,250 | |
| Machinery and equipment | 139,000 | 5 years |
| Total assets acquired | 1,082,537 | |
| Liabilities assumed | — | |
| Total preliminary purchase price | $ 1,082,537 | |

Set forth below is the unaudited pro forma revenue, operating loss, net loss and loss per share of the Company as if DPI had been acquired by the Company as of January 1, 2008:

| | **Year Ended December 31, (unaudited) 2008** |
|---|---|
| Revenue | $ 14,119,500 |
| Gross profit | 5,886,063 |
| Net Loss | (8,717,790) |
| Basic and diluted loss per share | (0.62) |

**NOTE 10. – OTHER INCOME**

The Company received approximately $416,000 in 2009 for New York State Qualified Emerging Technology Company ("QETC") refundable tax credits for the tax years ended 2005, 2006, and 2007 which the Company received in December, 2009.

In May 2008, the Company was awarded a judgment of approximately $126,000 pursuant to a positive judgement for the Company in its counterclaim the matter "Frank LaLoggia v. Document Security Systems, Inc", which the Company won in June 2006. The Company expects to collect the full amount of the judgment.

**NOTE 11. - INCOME TAXES**

Following is a summary of the components giving rise to the income tax provision (benefit) for the years ended December 31:

**The provision (benefit) for income taxes consists of the following:**

| | 2009 | 2008 |
|---|---|---|
| Currently payable: | | |
| Federal | $ - | $ - |
| State | - | - |
| Total currently payable | - | - |
| Deferred: | | |
| Federal | (1,113,695) | (2,583,341) |
| State | (265,310) | (616,339) |
| Total deferred | (1,379,005) | (3,199,680) |
| Less increase in allowance | 1,397,957 | 3,218,641 |
| Net deferred | 18,952 | 18,961 |
| Total income tax provision | $ 18,952 | $ 18,961 |

**Individual components of deferred taxes are as follows:**

| | 2009 | 2008 |
|---|---|---|
| **Deferred tax assets:** | | |
| Net operating loss carry forwards | $ 10,330,310 | $ 9,321,843 |
| Depreciation and amortization | | |
| Equity issued for services | 1,006,186 | 1,010,084 |
| Other | 425,619 | 104,299 |
| Total | 11,762,115 | 10,436,226 |
| Less valuation allowance | (11,600,983) | (10,342,023) |
| Gross deferred tax assets | $ 161,132 | $ 94,203 |
| | | |
| **Deferred tax liabilities:** | | |
| Goodwill | $ 69,665 | $ 51,878 |
| Modification of equity awards for licensing agreeement | - | - |
| Depreciation and amortization | 162,297 | 94,203 |
| Gross deferred tax liabilities | $ 231,962 | $ 146,081 |
| | | |
| Net deferred tax liabilities | $ (70,830) | $ (51,878) |

The Company has approximately $28,034,000 in net operating loss carryforwards ("NOL's") available to reduce future taxable income, of which approximately $1,412,000 is subject to change of control limitations that generally restricts the utilization of the NOL per year and $2,400,000 of the NOL will be allocated to contributed capital when subsequently realized. Due to the uncertainty as to the Company's ability to generate sufficient taxable income in the future and utilize the NOL's before they expire, the Company has recorded a valuation allowance accordingly a portion of the net operating loss carryforward, amounting to approximately $990,000, relates to tax deductions for stock awards, options and warrants exercised subsequent to the implementation of SFAS 123(R), which are not included in the determination of the deferred tax asset above and will be recognized in accordance with SFAS 123(R) and FIN48, when realized for tax purposes. These carryforwards expire at various dates from 2022 through 2028. In addition, a portion of the valuation allowance amounting to approximately $318,000 will be recorded as a reduction to additional paid in capital in the event that it is determined that a valuation allowance is no longer considered necessary.

The differences between the United States statutory federal income tax rate and the effective income tax rate in the accompanying consolidated statements of operations are as follows:

| | 2009 | 2008 |
|---|---|---|
| Statutory United States federal rate | 34% | 34% |
| State income taxes net of federal benefit | 4.4 | 5 |
| Permanent differences | (3.8) | (0.3) |
| Change in valuation reserves | (35.1) | (38.9) |
| Effective tax rate | (0.5)% | (0.2)% |

In July 2006, the FASB released Interpretation No. 48, “Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement 109” (“FIN48”). Effective for fiscal years beginning after December 15, 2006, FIN48 provides guidance on the financial statement recognition and measurement for income tax positions that we have taken or expect to take in our income tax returns. It also provides related guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. We adopted the provisions of FIN48 on January 1, 2007. The adoption did not have a material impact on the Company’s consolidated results of operations and financial position, and therefore, the Company did not have any adjustment to the January 1, 2007 beginning balance of retained earnings.

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

| | |
|---|---|
| Unrecognized tax benefits balance at January 1, 2008 | $ — |
| Gross increase for tax positions of prior years | 446,000 |
| Unrecognized tax benefits balance at January 1, 2009 | $ 446,000 |
| Unrecognized tax benefits balance at December 31, 2009 | $ 446,000 |

At December 31, 2009, the total unrecognized tax benefits of $446,000 have been netted against the related deferred tax assets.

The Company recognizes interest accrued and penalties related to unrecognized tax benefits in tax expense. During the years ended December 31, 2009 and 2008 the Company recognized no interest and penalties.

The Company files income tax returns in the U.S. federal jurisdiction and various states. The tax years 2006-2008 generally remain open to examination by major taxing jurisdictions to which the Company is subject.

**NOTE 12. - DEFINED CONTRIBUTION PENSION PLAN**

The Company established an Employee savings plan (the “401(k) Plan”) in 2006 which qualifies as a deferred salary arrangement under Section 401(k) of the Internal Revenue Code. Employees become eligible to participate in the Plan at the beginning of the following quarter after the employee’s hire date. Employees may contribute up to 20% of their pay to the Plan, subject to the limitations of the Internal Revenue Code. Company matching contributions are discretionary. Pursuant to the 401(k) Plan, employees may elect to defer a portion of their salary on a pre-tax basis. During the years ended December 31, 2009 and 2008, the Company did not make any matching contributions.

**NOTE 13. – COMMITMENTS AND CONTINGENCIES**

***Facilities*** - The Company leases a total of approximately 55,000 square feet of office space for its administrative offices and its printing facilities at a monthly rental aggregating approximately $36,000. The leases expire through July 2014, although renewal options exist to extend lease agreements for up to an additional 60 months.

***Equipment Leases*** - The Company leases digital and offset presses, laminating and finishing equipment for its various printing operations. The leases may be capital leases or operating leases and are generally for a term of 36 to 60 months. The leases expire through March 2016.

A summary of lease commitments at December 31, 2009 are as follows:

| | Capital Leases | Operating Leases Equipment | Operating Leases Facilities | Operating Leases Total |
|---|---|---|---|---|
| Payments made in 2009 | $ 123,878 | $ 471,326 | $ 440,575 | $ 911,901 |
| Future minimum lease commitments: | | | | |
| 2010 | 107,052 | 662,071 | 434,782 | 1,096,853 |
| 2011 | 107,052 | 625,218 | 467,639 | 1,092,857 |
| 2012 | 94,453 | 439,912 | 355,540 | 795,452 |
| 2013 | 5,665 | 296,284 | 365,366 | 661,650 |
| 2014 | - | 245,100 | 153,898 | 398,998 |
| Thereafter | - | 282,750 | - | 282,750 |
| Total future minimum lease commitments | $ 314,222 | $ 2,551,335 | $1,777,225 | $4,328,560 |
| Less amount representing interest | (53,631) | | | |
| Present value of future minimum lease commitments | 260,591 | | | |
| Less current portion | (78,167) | | | |
| Long term portion | $ 182,424 | | | |

***Employment agreements -*** The Company has employment agreements having terms in excess of one year with four members of its management team with terms ranging from three to five years through December 2013. The agreements provide for severance payments of between 12 and 18 months of salary in the event of termination for certain causes. As of December 31, 2009, the minimum annual severance payments under these employment agreements are, in aggregate, approximately $743,000.

In May 2008, the Company entered into a Separation Agreement with its former President that, among other things, accelerated the vesting of 33,333 shares of restricted common stock of the Company that were previously awarded to the former President pursuant to the Company's 2004 Employee Stock Option Plan so that such shares vested in equal monthly installments during the immediately following ten months. The Separation Agreement further provided that if the former President did not realize at least $212,000 in gross proceeds from the sale of such 33,333 shares of restricted stock upon their vesting, then the Company would pay the former President the amount that such proceeds is less than $212,000 in cash or additional shares of common stock of the Company. As of June 30, 2009, all 33,333 shares had vested generating gross proceeds of approximately $99,000. The Company has agreed to issue up to 30,000 shares of stock to pay the remaining amount due of $113,000. As of December 31, 2009, $74,000 remains due under the agreement and is recorded in accrued expenses as of December 31, 2009. Any remaining amounts due under the agreement after the shares are issued, if any, can be paid in cash or additional shares.

***Contingent Litigation Payment –*** In May 2005, the Company made an agreement with its legal counsel in charge of the Company's litigation with the European Central Bank which capped the fees for all matters associated with that litigation at $500,000 plus expenses, and a $150,000 contingent payment upon a successful ruling or settlement on the Company's behalf in that litigation. The Company will record the $150,000 in the period in which the Company has determined that a successful ruling or settlement is probable.

In addition, pursuant to an agreement made in December 2004, the Company is required to share the economic benefit derived from settlements, licenses or subsequent business arrangements that the Company obtains from any infringer of patents formerly owned by the Wicker Family. For infringement matters involving certain U.S. patents, the Company will be required to disburse 30% of the settlement proceeds. For infringement matters involving certain foreign patents, the Company will be required to disburse 14% of the settlement proceeds. These payments do not apply to licenses or royalties to patents that the Company has developed or obtained from persons other than the Wicker Family. As of December 31, 2009, there have been no settlement amounts related to these agreements.

***Legal Proceedings*** On August 1, 2005, the Company commenced a suit against the European Central Bank ("ECB") alleging patent infringement by the ECB and claimed unspecified damages. We brought the suit in the European Court of First Instance in Luxembourg. We alleged that all Euro banknotes in circulation infringe the Company European Patent 0 455 750B1 (the "Patent"), which covers a method of incorporating an anti-counterfeiting feature into banknotes or similar security documents to protect against forgeries by digital scanning and copying devices. The Court of First Instance ruled on September 5, 2007 that it does not have jurisdiction to rule on the patent infringement claim, and also ruled that we will be required to pay attorneys and court fees of the ECB. The ECB formally requested the Company to pay attorneys and court fees in the amount of Euro 93,752 which, unless the amount is settled will be subject to an assessment procedure that will not likely be concluded until late 2010, which the Company will accrue as soon as the assessed amount, if any, is reasonably estimatable.

On March 24, 2006, the Company received notice that the ECB had filed a separate claim in the United Kingdom and Luxembourg courts seeking the invalidation of the Patent. Proceedings were commenced before the national courts seeking revocation and declarations of invalidity of the Patent in each of the Netherlands, Belgium, Italy, France, Spain, Germany and Austria. On March 26, 2007, the High Court of Justice, Chancery Division, Patents Court in London, England (the "English Court") ruled that the Patent was deemed invalid in the United Kingdom, and on March 19, 2008 this decision was upheld on appeal. The English Court rejected the ECB's allegations of invalidity based on lack of novelty, lack of inventive step and insufficiency, but held that the patent was invalid for added subject matter. The English Court's decision does not affect the validity of the Patent in other European countries. As a result of these decisions, the Company was notified of the final assessment of the reimbursable ECB costs for both court cases was ₤356,490, of which the Company has paid ₤332,000 through December 31, 2009 and owes approximately ₤25,000 (approximately $40,000 as of December 31, 2009), which amount was included in accrued expenses as of December 31, 2009.

On March 27, 2007 the Bundespatentgericht of the Federal Republic of Germany ruled that the German part of the Patent was valid, having considered the English Court's decision. As a result of this ruling, the Company expects to be awarded reimbursements for its costs associated with the German validity case, which is Euro 44,692 ($65,000 at December 31, 2009), which the Company will record when the amount, if any, is received. The ECB has filed an appeal against that decision, which is not expected to be decided before July 2010. On January 9, 2008 the French Court held that the Patent was invalid in France for the same reasons given by the English Court. The Company is required to pay de minimus attorneys' fees of the ECB as a result of the French decision. The Company filed an appeal against the French decision on May 7, 2008. The French appeal was heard on December 7, 2009. On March 20, 2010, the Company was informed that the decision was upheld in the French appeal. On March 12, 2008 the Dutch Court, having considered the English, German and French decisions, ruled that the Patent is valid in the Netherlands. The ECB filed an appeal against the Dutch decision on March 27, 2008. The Dutch appeal will be heard in the Hague on June 2010. On November 3, 2009, the Belgium Court held that the Patent was invalid in Belgium for the same reasons given by the English and French courts as were similarly informed by the Austrian court on November 17, 2009. Costs reimbursements, if any, associated with the Belgium and Austrian validity case are covered under the Trebuchet Agreement as described below. A trial was also held in Madrid, Spain on June 3 and 5, 2008 and oral and written closing submissions were made on July 19, 2008. On March 24, 2010 the Spanish Court ruled that the Patent was valid. In Italy the validity case is to be heard again by a newly appointed judge during 2010 and a hearing in Luxembourg is expected in 2010.

On August 20, 2008, the Company entered into an agreement with Trebuchet Capital Partners, LLC ("Trebuchet") under which Trebuchet has agreed to pay substantially all of the litigation costs associated with pending validity proceedings initiated by the European Central Bank ("ECB") in eight European countries relating to the Company's European Patent 0 455 750B1 that the Company has claimed the ECB infringed in printing of the Euro currency (the "Patent"). Trebuchet also agreed to pay substantially all of the litigation costs associated with future validity challenges filed by the ECB or other parties, provided that Trebuchet elects to assume the defense of any such challenges, in its sole discretion, and patent infringement suits filed against the ECB and certain other alleged infringers of the Patent, all of which suits may be brought at the sole discretion of Trebuchet and may be in the name of the Company, Trebuchet or both. The Company provided Trebuchet with the sole and exclusive right to manage infringement litigation relating to the Patent in Europe, including the right to initiate litigation in the name of the Company, Trebuchet or both and to choose whom and where to sue, subject to certain limitations set forth in the agreement under the terms of the Agreement, and in consideration for Trebuchet's funding obligations, the Company assigned and transferred a 49% interest of the Company's rights, title and interest in the Patent to Trebuchet which allows Trebuchet to have a separate and distinct interest in and share of the Patent, along with the right to sue and recover in litigation, settlement or otherwise to collect royalties or other payments under or on account of the Patent. In addition, the Company and Trebuchet have agreed to equally share all proceeds generated from litigation relating to the Patent, including judgments and licenses or other arrangements entered into in settlement of any such litigation. Trebuchet is also entitled to recoup any litigation expenses specifically awarded to the Company in such actions.

The Patent has thus been confirmed to be valid and enforceable in three jurisdictions (Germany, the Netherlands and Spain) that use the Euro as its national currency allowing the Company or Trebuchet Capital Partners, on the Company's behalf, to proceed with infringement cases in these countries if we choose to do so. On February 18, 2010, Trebuchet, on behalf of Document Security Systems, filed an infringement suit in the Netherlands. The suit is being lodged against the ECB and two security printing entities with manufacturing operations in the Netherlands, Joh. Enschede Banknotes B.V.; and Koninklijke Joh. Enschede B.V. The ECB's and the security printers have been notified and the court hearing date is tentatively scheduled for January 21, 2011.

On January 31, 2003, the Company commenced an action, unrelated to the above ECB litigation, entitled New Sky Communications, Inc., As Successor-In-Interest To Thomas M. Wicker, Thomas M.Wicker Enterprises, Inc. and Document Security Consultants V. Adler Technologies, Inc. N/K/A Adlertech International, Inc. and Andrew McTaggert (United States District Court, Western District Of New York Case No.03-Cv-6044t(F)) regarding certain intellectual property in which the Company has an interest. On December 7, 2009, the Company reached an agreement to terminate all litigation in association with this suit. In conjunction with that agreement, the Company issued to the opposing parties an aggregate of 40,000 shares of common stock valued at approximately $85,000 and 50,000 of common stock warrants for the purchase of common shares at $3.00 per share valued at approximately $30,000 utilizing the Black Scholes pricing model. The Company recorded an expense related to the estimated grant date fair value of the shares and warrants issued of approximately $115,000. In addition, both parties agreed not to compete with certain of the other party's customers for 7 years. The Company does not believe that the competition agreement will have a material impact on its business.

In addition to the foregoing, we are subject to other legal proceedings that have arisen in the ordinary course of business and have not been finally adjudicated. Although there can be no assurance in this regard, in the opinion of management, none of the legal proceedings to which we are a party, whether discussed herein or otherwise, will have a material adverse effect on our results of operations, cash flows or our financial condition.

**NOTE 14. - SUPPLEMENTAL CASH FLOW INFORMATION**

| | | |
|---|---|---|
| Cash paid for interest | $ 157,000 | $ 69,000 |
| | | |
| Non-cash investing and financing activities: | | |
| Conversion of debt to equity | 2,000,000 | - |
| Equity issued for severance agreements | 55,000 | 129,000 |
| Equity issued for prepaid services | 56,000 | - |
| Equity issued for to satisfy an obligation | - | 94,000 |
| Equipment purchased via capital lease | 63,000 | - |
| Deferred tax liability offsetting additional paid in capital | - | (156,000) |
| Warrants issued with debt | 72,000 | 256,000 |
| Beneficial conversion features of convertible debt | 351,000 | - |
| Equity method investment received in exchange for the assets and liabilities of Legalstore.com | 350,000 | - |

**NOTE 15. - SEGMENT INFORMATION**

The Company's businesses are organized, managed and internally reported as four operating segments. Each of these operating segments, Document Security Systems, Plastic Printing Professionals, and DPI Secuprint, are engaged in various aspects of developing and applying printing technologies and procedures to produce, or allow others to produce, documents with a wide range of features, including the Company's patented technologies and trade secrets. For the purposes of providing segment information, these three operating segments have been aggregated into one reportable segment. A summary of the two segments is as follows:

**Security and Commercial Printing** License, manufacture and sale of patented document security technologies, including digital security print solutions, and general commercial printing, primarily on paper and plastic. Comprises the operations of Document Security Systems, Plastic Printing Professionals, and DPI Secuprint, which the Company acquired on December 18, 2008.

**Legal Supplies** Sale of specialty legal supplies, primarily to lawyers and law firms located throughout the United States as Legalstore.com. During the fourth quarter of 2009, the Company sold its legal products business.

Approximate information concerning the Company's operations by reportable segment as of and for the year ended December 31, 2009 and 2008 is as follows. The Company relies on intersegment cooperation and management does not represent that these segments, if operated independently, would report the results contained herein:

| 2009 | Legal Supplies | Security and Commercial Printing | Corporate | Total |
|---|---|---|---|---|
| Revenues from external customers | $ 355,000 | $ 9,556,000 | $ - | $ 9,911,000 |
| Interest Expense and amortization of note discount | - | 363,000 | 146,000 | 509,000 |
| Stock based payments | - | - | 292,000 | 292,000 |
| Depreciation and amortization | 16,000 | 1,644,000 | 2,000 | 1,662,000 |
| Operating (loss) profit | 40,000 | (2,353,000) | (1,400,000) | (3,713,000) |
| Capital Expenditures | - | 302,000 | - | 302,000 |
| Identifiable assets | - | 6,276,000 | 439,000 | 6,715,000 |
| **2008** | | | | |
| Revenues from external customers | $ 610,000 | $ 6,033,000 | $ - | $ 6,643,000 |
| Interest Expense and amortization of note discount | - | - | 145,000 | 145,000 |
| Stock based payments | - | 1,148,000 | 599,000 | 1,747,000 |
| Depreciation and amortization | 15,000 | 2,269,000 | 4,000 | 2,288,000 |
| Impairment of patent defense costs and other intangible assets | - | 797,000 | - | 797,000 |
| Loss on sale of patent | - | (1,170,000) | - | (1,170,000) |
| Operating (loss) profit | (6,000) | (4,709,000) | (2,304,000) | (7,019,000) |
| Capital Expenditures | 12,000 | 1,669,000 | 3,000 | 1,684,000 |
| Identifiable assets | 252,000 | 7,705,000 | 100,000 | 8,057,000 |

International revenue, which consists of sales to customers with operations in Western Europe, Latin America, Africa, Mddle East and Asia comprised 3% of total revenue for 2009, (4%- 2008). Revenue is allocated to individual countries by customer based on where the product is shipped to, location of services performed or the location of equipment that is under an annual maintenance agreement. The Company had no long-lived assets in any country other than the United States for any period presented.

***Major Customers*** –

During 2009, two customers in the security and commercial printing segment accounted for 19% and 12% of the Company's total revenue, respectively. As of December 31, 2009, two customer account receivable balances accounted for 21% and 17% of the Company's trade accounts receivable balance, respectively. During 2008, two customers in the security and commercial printing segment accounted for 11% and 10% of the Company's total revenue from continuing operations, respectively. As of December 31, 2008, one customer account receivable balance that was acquired as part of the Company's acquisition of the assets of a commercial printer in December 2008, accounted for 42% of the Company's trade accounts receivable balance.

**NOTE 16. – SUBSEQUENT EVENTS**

*Business Combination*

On February 12, 2010, the Company acquired all of the outstanding common stock of Premier Packaging Corporation from Robert B. and Joan T. Bzdick for $2,000,000 in cash and 735,437 shares of the Company's common stock. The cash payment was subject to a working capital adjustment which was not required as the working capital was within the target range. In addition, the purchase price is subject to increase if the capital gains tax rate that was in effect as of February 12, 2010 is retroactively increased by legislation or otherwise whereas the seller's tax on its gain increases. Any increase in taxes will be payable by the Company in either cash or stock. The Company believe this contingent payment is remote. In addition, the seller has registration rights for its shares to which the Company is subject to registration penalties of up to $5,000 per month after 120 days.

In connection with the transaction, the Company incurred secured bank debt in the principal amount of $1,500,000 which was used to partially satisfy the purchase price of the Premier common stock. In conjunction with the transaction, the Company entered into a Credit Facility Agreement with RBS Citizens, N.A. ("Citizens Bank") pursuant to which Citizens Bank provided Premier Packaging Corporation with a term loan of $1,500,000, and a revolving line of up to $1,000,000. The Credit Facility Agreement contains customary representations and warranties, affirmative and negative covenants, including financial covenants (minimum coverage ratio, debt to EBITDA ratio, and current ratio requirements) and events of default and is secured by all of the assets of Premier Packaging Corporation. The credit facilities are also secured by cross guarantees by Document Security Systems, Inc., and its other wholly owned subsidiaries, Plastic Printing Professionals, Inc. and Secuprint, Inc. The $1,500,000 term loan matures March 1, 2013 and is payable in 35 monthly payments of $25,000 plus interest commencing March 1, 2010 and a payment of $625,000 on the 36 month. Interest accrues at 1 Month LIBOR plus 3.75%. The proceeds of the term loan were used as partial payment of the purchase of all of the outstanding common stock of Premier Packaging Corporation. The revolving line of credit up to $1,000,000 is accessible by the Premier Packaging division subject to certain terms matures on February 12, 2011 and is payable in monthly installments of interest only beginning on March 1, 2010. Interest accrues at 1 Month LIBOR plus 3.75%. The Company subsequently entered into a credit swap agreement to lock into a 5.66% effective interest over the life of the term loan.

The Company has engaged a valuation expert to assist management in determining the fair value of the assets acquired. The preliminary estimate of the fair value of assets and liabilities acquired as a result of this business combination were as follows:

| | |
|---|---|
| Fair value of the consideration transferred | $4,566,675 |
| | |
| Cash | 5,290 |
| Accounts receivable | 1,284,227 |
| Inventory and work in process | 504,162 |
| Machinery and equipment | 1,557,500 |
| Goodwill and other intangible assets | 1,999,360 |
| Total Assets | 5,350,539 |
| | |
| Liabilities assumed | |
| Accounts payable | 448,128 |
| Short-term cash overdraft | 277,645 |
| Accrued Liabilities | 58,091 |
| Total Liabilities | 783,864 |
| | |
| Total preliminary purchase price | $4,566,675 |

Set forth below is the unaudited pro forma condensed balance sheet and profit and loss statements of the Company as if Premier Packaging had been acquired by the Company as of January 1, 2009, adjusted for intercompany sales, intercompany tax benefits, and contractual cost reductions as a result of the purchase agreement and employment contract.

## Pro- Forma Profit & Loss Statement For the Twelve Months Ended December 31, 2009

| | Document Security Systems | Premier Packaging Corp. (Unaudited) | Pro-Forma Adjustments (Unaudited) | Consolidated (Unaudited) |
|---|---|---|---|---|
| Total Revenue | 9,911,691 | 6,938,000 | (194,000)a | 16,655,691 |
| Total costs of revenue | 6,256,399 | 4,973,000 | (194,000)a | 11,035,399 |
| Gross profit | 3,655,292 | 1,965,000 | - | 5,620,292 |
| Operating expenses | 7,367,551 | 1,434,000 | (170,000)b | 8,631,551 |
| Operating (loss) profit | (3,712,259) | 531,000 | 170,000 | (3,011,259) |
| Other income (expense): | | | | |
| Interest income | 18,140 | - | | 18,140 |
| Interest expense | (509,020) | (1,000) | (75,000)c | (585,020) |
| Other Income | 232,078 | (1,000) | | 231,078 |
| Other income (expense) | (258,802) | (2,000) | (75,000) | (335,802) |
| Income (loss) before income taxes | (3,971,061) | 529,000 | 95,000 | (3,347,061) |
| Income Tax Expense | 18,952 | 1,000 | - | 19,952 |
| Net (loss) income | $ (3,990,013) | $ 528,000 | $ 95,000 | $ (3,367,013) |
| Net loss per share - basic and diluted: | (0.27) | | | (0.22) |
| Weighted average common shares outstanding, basic and diluted | 14,700,453 | 735,437 | | 15,435,890 |

a- Elimination of intercompany sales and offsetting cost of sales

b- Contractual reductions of rent and officer compensation expense

c- Interest expense on Term Note used to finance a portion of the purchase price

**Pro- Forma Condensed Consolidated Balance Sheets**
**As of December 31, 2009**

| ASSETS | Document Security Systems | Premier Packaging Corp (Unaudited) | Pro-forma adjustments (Unaudited) | | Consolidated (Unaudited) |
|---|---|---|---|---|---|
| **Current assets:** | | | | | |
| Cash and cash equivalents | $ 448,895 | $ 37,069 | $ (500,000) | b | $ 485,964 |
| | | | 500,000 | c | |
| Accounts receivable net of allowance | 1,143,939 | 898,513 | (66,506) | a | 1,975,946 |
| Inventory | 184,174 | 637,061 | - | | 821,235 |
| Prepaid expenses and other current assets | 91,310 | - | - | | 91,310 |
| Total current assets | 1,868,318 | 1,572,643 | (66,506) | | 3,374,455 |
| **Fixed assets, net** | 1,286,226 | - | 1,557,500 | b | 2,843,726 |
| **Other assets** | 305,507 | - | - | | 305,507 |
| **Investment** | 350,000 | - | - | | 350,000 |
| **Goodwill** | 1,315,721 | - | 959,500 | b | 2,275,221 |
| **Other intangible assets, net** | 1,588,969 | - | 1,000,000 | b | 2,588,969 |
| **Total assets** | $ 6,714,741 | $ 1,572,643 | $ 3,450,494 | | $ 11,737,878 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | | | | |
| **Current liabilities:** | | | | | |
| Accounts payable | $ 1,673,901 | $ 472,994 | $ (66,506) | a | $ 2,080,389 |
| Accrued expenses & other current liabilities | 934,595 | 22,481 | - | | 957,076 |
| Short-term debt | - | - | 300,000 | b | 300,000 |
| Current portion of capital lease obligations | 78,167 | - | - | | 78,167 |
| Total current liabilities | 2,686,663 | 495,475 | 233,494 | | 3,415,632 |
| **Revolving notes from related parties** | 583,000 | - | - | | 583,000 |
| **Long term debt, net of unamortized discount of $420,000** | 954,616 | - | 1,200,000 | b | 2,154,616 |
| **Capital lease obligations** | 182,424 | - | - | | 182,424 |
| **Deferred tax liability** | 70,830 | - | - | | 70,830 |
| **Stockholders' equity** | 2,237,208 | 1,077,168 | 1,517,000 | b | 5,331,376 |
| | | | 500,000 | c | |
| **Total liabilities and stockholders' equity** | $ 6,714,741 | $ 1,572,643 | $ 3,450,494 | | $ 11,737,878 |

a- Pro-forma adjustments for accounts receivable and accounts payable in each company for pre-acquisition billings owed/collectible to each party that will be eliminated in consolidation post acquistion.
b- Adjustment to reflect consideration paid and assets acquired
c- Pro-forma adjustment to remove Premier Packaging shareholder distributions

***Private Placement and Warrants Exercised***

On February 17, 2010, the Company completed the sale of 20 investment units in a private placement pursuant to subscription agreements with six accredited investors. Each investment unit was comprised of 5,000 shares of the Company's common stock and five year warrants to purchase 1,000 shares of common stock at an exercise price of $3.50 per share. In the transaction, the Company sold 20 investment units for $15,000 per unit for gross cash proceeds of $300,000, consisting of 100,000 shares of common stock and warrants to purchase an aggregate of 20,000 shares of common stock. In connection with these sales EKN Financial Services Inc., a registered broker-dealer, acted as non-exclusive placement agent. EKN Financial Services, Inc. received a cash fee in the aggregate of $30,000 as commission for these sales. On February 17, 2010, the Company also sold 20 investment units for gross cash proceeds of $270,000, consisting of 100,000 shares of common stock and warrants to purchase an aggregate of 20,000 shares of common stock. No placement agent fees were paid on these sales.On February 23, 2010, the

Company issued 304,000 shares of common stock pursuant to the exercise of warrants in which the Company received proceeds of $608,000.

**SIGNATURES**

In accordance with Section 13 or 15(d) of the Exchange Act of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**DOCUMENT SECURITY SYSTEMS, INC.**

March 24, 2010 By: /s/ Patrick White
Patrick White
Chief Executive Officer

In accordance with Section 13 or 15(d) of the Exchange Act of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

March 24, 2010 By: /s/ Robert Fagenson
Robert Fagenson
Director

March 24, 2010 By: /s/ Patrick White
Patrick White
Chief Executive Officer and Director
(Principal Executive Officer)

March 24, 2010 By: /s/ David Wicker
David Wicker
Vice President and Director

March 24, 2010 By: /s/ Timothy Ashman
Timothy Ashman
Director

March 24, 2010 By: /s/ Alan E. Harrison
Alan E. Harrison
Director

March 24, 2010 By: /s/ Ira A. Greenstein
Ira A. Greenstein
Director

March 24, 2010 By: /s/ Philip Jones
Philip Jones
Chief Financial Officer

Exhibit 21.0

**SUBSIDIARIES OF REGISTRANT**

Document Security Systems, Inc. acknowledges that the following corporations are subsidiaries of the Registrant:

Document Security Consultants, Inc. (New York) (100%)
Thomas M. Wicker Enterprises, Inc. (New York) (100%)
Lester Levin, Inc. (New York) (100%)
Secured Document Systems, Inc. (New York) (100%)
Plastic Printing Professionals, Inc. (New York) (100%)
Secuprint, Inc. (New York) (100%)
Premier Packaging Corp. (New York) (100%)

Exhibit 23.1

**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

We consent to the incorporation by reference in Registration Statement No. 333-134034 (Form S-8) and Registration Statement No. 333-128437 (Form S-8) and Registration Statement No. 333-116317 (Form S-3) and Registration Statement No. 333-125373 (Form S-3) and Registration Statement No. 333-141871 (Form S-3) of Document Security Systems, Inc and Subsidiaries of our report, dated March 24, 2010, on the consolidated financial statements as of and for the year ended December 31, 2009, appearing in this Annual Report on Form 10-K of Document Security Systems, Inc. and Subsidiaries for the year ended December 31, 2009.

FREED MAXICK & BATTAGLIA, CPAs, PC

Buffalo, New York
March 24, 2010

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Exhibit 31.1

**CERTIFICATION PURSUANT TO**

**18 U.S.C. SECTION 1350,**

**AS ADOPTED PURSUANT TO**

**SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Patrick White, certify that:

1. I have reviewed this annual report on Form 10-K of Document Security Systems, Inc.

2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors:

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 24, 2010
/s/ Patrick White

Patrick White
Chief Executive Officer

Exhibit 31.2

**CERTIFICATION PURSUANT TO**

**18 U.S.C. SECTION 1350,**

**AS ADOPTED PURSUANT TO**

**SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Philip Jones, certify that:

1. I have reviewed this annual report on Form 10-K of Document Security Systems, Inc.

2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors:

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 24, 2010
/s/ Philip Jones

Philip Jones
Chief Financial Officer

Exhibit 32.1

**CERTIFICATION PURSUANT TO**

**18 U.S.C. SECTION 1350,**

**AS ADOPTED PURSUANT TO**

**SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of Document Security Systems, Inc. (the "Company") on Form 10-K for the year ending December 31, 2009 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Patrick White, Chief Executive Officer, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

Date: March 24, 2010
/s/ Patrick White
Patrick White
Chief Executive Officer

Exhibit 32.2

**CERTIFICATION PURSUANT TO**

**18 U.S.C. SECTION 1350,**

**AS ADOPTED PURSUANT TO**

**SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of Document Security Systems, Inc. (the “Company”) on Form 10-K for the year ending December 31, 2009 as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, Philip Jones, Controller and Principal Accounting Officer, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

Date: March 24, 2010
/s/ Philip Jones

Philip Jones
Chief Financial Officer