

NEON SYSTEMS INC  
Form 10-K/A  
July 29, 2003

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**Form 10-K/A**

(Mark One)

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

For the Fiscal Year Ended March 31, 2003

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 0-25457

**NEON Systems, Inc.**

(Exact name of Registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**76-0345839**  
(I.R.S. Employer Identification No.)

**14100 Southwest Freeway, Suite 500,**  
**Sugar Land, Texas**  
(Address of principal executive offices)

**77478**  
(zip code)

**(281) 491-4200**

(Registrant's telephone number, including area code)

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

<b>Title of Each Class</b>	<b>Name of each exchange on which registered</b>
None	None

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

**Common Stock, par value \$0.01 per share**

(Title of Class)

Indicate by check mark whether 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 Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes  No

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

This Amendment No. 1 on Form 10-K/A amends Part III of the original Annual Report on Form 10-K (the Original Form 10-K) filed on June 28, 2003, on behalf of the Registrant.

Items 10-13 of Part III of the Original Form 10-K are hereby amended in their entirety to read as follows:



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**PART III**
**Item 10. Directors and Executive Officers of Registrant**

Our executive officers, their ages as of July 25, 2003, and certain additional information about them are as follows:

<u>Name</u>	<u>Age</u>	<u>Position</u>
John J. Moores	59	Chairman of the Board of Directors
Mark J. Cresswell	38	President and Chief Operating Officer
Brian D. Helman	33	Chief Financial Officer and Secretary
Jonathan Reed	47	Vice President of Product Marketing and Channel Sales
Chris Garner	47	Vice President of Research & Development
Shelby R. Fike	44	Vice President and General Counsel
Charles E. Noell III	51	Director
Norris van den Berg	64	Director
Peter Schaeffer	47	Director
George H. Ellis	54	Director
Richard Holcomb	41	Director
David F. Cary	47	Director
Loretta Cross	46	Director

Set forth below is information concerning the age and business experience of our directors and executive officers.

**John J. Moores**, age 59, has served as Chairman of our Board of Directors since May 1993. From June 2001 to October 15, 2001, Mr. Moores also served as NEON's Interim Chief Executive Officer. Since December 1994, Mr. Moores has served as owner and Chairman of the Board of the San Diego Padres Baseball Club, L.P. and since September 1991 as Chairman of the Board of JMI Services, Inc., a private investment company. In 1980, Mr. Moores founded BMC Software, Inc., a vendor of system software utilities, and served as its President and Chief Executive Officer until 1986 and as its Chairman of the Board until 1992. Mr. Moores also serves as Chairman of the Board of numerous privately held companies, including Skunkware, Inc. and Scalable Software, Inc. Mr. Moores also served as a director of Peregrine Systems, Inc., an infrastructure management software company from 1989 to 2002 and served as its Chairman from March 1990 to July 2000 and again beginning May 6, 2002. From October 1997 until August 2000, Mr. Moores also served as a director of BindView Development Corporation, a systems management software company. Mr. Moores holds a B.S. in Economics and a J.D. from the University of Houston.

**Mark J. Cresswell**, age 38, NEON's President and Chief Operating Officer since March 2003, joined NEON Systems in October 2001 as Vice President and General Manager of the Shadow group. Mr. Cresswell joined NEON from Framesoft, an investment banking software company based in Switzerland. Prior to Framesoft, Cresswell joined NEON Systems in 1995 serving as Managing Director of the United Kingdom (UK) and Benelux operations. As one of NEON Systems' first international employees, Cresswell was in charge of managing the UK operations for NEON for 5 years. Prior to joining NEON, Mr. Cresswell has held various senior positions with several high-tech organizations. Mr. Cresswell is qualified in Pure and Applied Mathematics from Westcliff College in England.

**Brian D. Helman**, age 33, joined NEON Systems in May 2002 as vice president of finance and became NEON's Chief Financial Officer in June of 2002. Prior to joining NEON Systems, Helman served as vice president of finance and business planning for NetSpeak Corporation, a publicly held global provider of telecommunications software. Prior to joining Netspeak Corporation in 1996, Helman worked in the audit practice of Deloitte & Touche, LLP. Helman is a certified public accountant and holds a Bachelor of Science degree in finance from the

University of Florida.

**Jonathan Reed**, age 47, has served as NEON's Vice President, Business Development for NEON Systems since May 2000. From January 1998 through December 1998, Mr. Reed served as NEON's Director of Marketing. From July 1996 to December 1997, Mr. Reed served as NEON's Principal Consultant and Technical Marketing Manager. From April 1995 until July 1996, Mr. Reed served as Alliance Manager for Sybase, Inc., a distributed computing company. From March 1991 to April 1995, Mr. Reed was employed by BMC Software, Inc. where he served as a Commercial Analyst. Mr. Reed holds a B.S. in Biology from the University of Houston and an M.S. in Management and Computer Science from Houston Baptist University.

**Chris Garner**, age 47, NEON's Vice President of Research and Development since February 2003, joined NEON System in 2002 as a Director of Development. Prior to NEON Garner served as the Vice President of Research and Development at Altra Energy Technologies/Caminus Corporation, an energy trading and management software company based in Houston and New York. Prior to Altra, Garner was with BMC Software as the Director of Development in the Patrol division. Garner has held various senior positions with several high-tech organizations in both R&D and Product Management roles.

**Shelby R. Fike**, age 44, has served as NEON's Vice President and General Counsel since September 30, 2002 and has served NEON as a corporate attorney since May 2001. Prior to joining NEON, Mr. Fike served as corporate counsel and director of legal services for NetIQ Corporation from May 2000 to May 2001. Mr. Fike has also held corporate counsel positions with Mission Critical Software, Inc., a publicly held software company, from August 1998 to its acquisition by NetIQ Corporation in May 2000. Prior to Mission Critical Software, Mr. Fike served as corporate counsel to Learmonth & Burchett Management Systems Plc and for BSG Consulting, Inc. Prior to joining BSG Consulting, Inc., Mr. Fike was an associate attorney with Porter & Clements, P.C., and with Keck Mahin & Cate, LLC in their Corporate/M&A sections. Mr. Fike holds a Bachelor of Arts degree in Education from Texas Lutheran College and a J.D. degree from Baylor University School of Law.

**Charles E. Noell, III**, age 51, has served as a director since May 1993. Since January 1992, Mr. Noell has served as President and Chief Executive Officer of JMI Services, Inc., and as a General Partner of JMI Partners, L.P., which is the General Partner of JMI Equity Fund, L.P. From 1992 to 2002, Mr. Noell has served as a director of Peregrine Systems, Inc. Mr. Noell also serves on the board of numerous privately held companies, including NEON Enterprise Software, Inc. (formerly Peregrine/Bridge Transfer Corporation), Scalable Software, Inc. and Skunkware, Inc. Mr. Noell holds a B.A. in History from the University of North Carolina at Chapel Hill and an M.B.A. from Harvard University.

**Norris van den Berg**, age 64, has served as a director since May 1993. Mr. van den Berg has served as a General Partner of JMI Partners, L.P., which is the General Partner of JMI Equity Fund, L.P., since July 1991. Prior to joining JMI, Mr. van den Berg served in various management positions at IBM. Mr. van den Berg also served as a director of Peregrine Systems, Inc. from 1992 until October 2000, and is currently a director of NEON Enterprise Software, Inc. (formerly Peregrine/Bridge Transfer Corporation) and Skunkware, Inc. Mr. van den Berg holds a B.A. in Philosophy and Mathematics from the University of Maryland.

**Peter Schaeffer**, age 47, is NEON's founder and has been a member of our Board of Directors and of our predecessor-in-interest, NEON Systems, Inc., an Illinois corporation, since July 1991. From November 1995 to February 2001, Mr. Schaeffer served as our Chief Technology Officer. From July 1991 to October 1995, Mr. Schaeffer served as our President and Chief Executive Officer. From June 1990 to June 1991, Mr. Schaeffer was employed with Goal Systems International, Inc., a privately held software development company. In 1986, Mr. Schaeffer co-founded MVS Software, a privately held software development company, and was Vice President Technology of MVS Software until April 1990. Mr. Schaeffer is currently employed by JMI. Mr. Schaeffer holds a B.S. in Organic Chemistry from the University of Chicago.

**George H. Ellis**, age 54, has served as a director since January 2000. In October 2001, Mr. Ellis was retained to be the Chief Executive Officer, Chairman and a member of the Board of Directors of AremisSoft Corporation, a global supplier of enterprise-wide applications software that was experiencing financial issues and



an SEC investigation with respect to its prior management. In March of 2002, Mr. Ellis led AremisSoft Corporation in filing a petition to reorganize in bankruptcy in his turn-around efforts. In August of 2002, AremisSoft exited bankruptcy as a reorganized entity. Mr. Ellis also served as executive vice president and chief operating officer of the Communities Foundation of Texas from February 2000 until October 2001. Mr. Ellis served as Chief Financial Officer of Sterling Software, Inc. from 1985 through June 1996, and held a similar position with Sterling Commerce, Inc. from February 1996 through June 1996. From 1996 through 1999, Mr. Ellis was a full time law student and a business consultant providing consulting services to various technology-related companies. During this time he was also a Founder and Managing Director of Chaparral Ventures, Ltd., a Dallas-based venture capital firm focused on electronic commerce investment. Mr. Ellis also is a member of the Board of Advisors to the law school at Southern Methodist University and the Advisory Board of the Entrepreneurs Foundation of North Texas. Mr. Ellis is a Certified Public Accountant and an attorney in the State of Texas. Mr. Ellis holds a B.S. in Accounting from Texas Tech University and a J.D. from Southern Methodist University.

**Richard Holcomb**, age 41, has served as a director since May 1993. In March 2003, Mr. Holcomb cofounded and serves as the chief-executive officer and chairman of StrikeIron, a web services technology company. Prior to founding StrikeIron, Mr. Holcomb served as the interim CEO at GadgetSpace and oversaw its acquisition by Inphonic in 2001. In 1995 Mr. Holcomb co-founded HAHT Commerce, an e-commerce application provider, and served as its Chief Executive Officer and Chairman from 1995 until 2001. Prior to 1995, Mr. Holcomb co-founded Q+E Software, a privately held supplier of client/server database access technology, in 1986 and from 1986 through 1994 served as its Chief Executive Officer, President and Chairman. Q+E Software was acquired by Intersolv in 1994. Mr. Holcomb serves on several public advisory boards, including the North Carolina State University Graduate School Board of Advisors, the North Carolina Electronics and Information Technology Association (NCEITA), the Council for Entrepreneurial Development (CED) and is a former appointed member of the North Carolina Information Resources Management Commission. Mr. Holcomb is also a director of three privately-held software companies. Mr. Holcomb holds a B.S. degree in Computer Science from the University of South Carolina and an M.S. in Computer Science from North Carolina State University.

**David F. Cary**, age 47, was appointed to the Board of Directors as a Class III director and as a member of the Audit Committee on December 5, 2002. From 1992 to the present, Mr. Cary has served as Chief Financial Officer of, and in various other management capacities with, I2 Technologies, Inc., a public software company. Before joining I2 Technologies, Mr. Cary was an Accounting System Controller for ComputerLand Texas, a distributor of computer equipment, from December 1991 to June 1992. Mr. Cary is a Certified Public Accountant and holds a B.S. in accounting from San Francisco State University and an M.B.A. from Southern Methodist University.

**Loretta Cross**, age 46, was appointed to the Board of Directors as a Class III director and as a member of the Audit Committee on December 5, 2002. Ms. Cross is the Senior Managing Director for FTI Consulting, Inc., a private financial consulting firm, since its acquisition of the U.S. Business Recovery Services Division of PricewaterhouseCoopers in September 2002. From 1991 to August 30, 2002, Ms. Cross served as a Partner with PricewaterhouseCoopers, LLP. Before joining PricewaterhouseCoopers LLP, Ms. Cross was with Ernst & Young LLP and Touche Ross & Co. LLP. Since January 1, 2002, Ms. Cross has served as a director of the Texas Gulf Coast Lupis Foundation, a non-profit organization. Ms. Cross is a Certified Public Accountant and holds a B.B.A. in accounting from University of Texas at Austin.

#### **Section 16(a) Beneficial Ownership Reporting Compliance**

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires that our executive officers and directors, and beneficial owners of more than ten percent (10%) of any class of equity security registered pursuant to the Securities Act of 1933, as amended, make certain filings with the SEC and the Company. We believe, based on information provided to us by the reporting persons, that during the fiscal year ended March 31, 2003, all directors, officers and ten percent (10%) beneficial owners timely complied with such filing requirements.



**Item 11. Executive Compensation**

The following table sets forth for the fiscal years indicated the compensation earned by our former Chief Executive Officer, Louis R. Woodhill, our current principal executive officer, Mark Cresswell, President and Chief Operating Officer, and each of our four most highly compensated executive officers who were serving as officers at the end of the fiscal year ended March 31, 2003 (collectively, the Named Executive Officers):

**SUMMARY COMPENSATION TABLE (1)**

Name and Principal Position (a)	Year	Annual Compensation			Long-Term Compensation			All Other Compensation (\$)
		Salary (\$)	Bonus	Other Annual Compensation (\$)	Awards		Payouts	
					Restricted Stock Award(s) (\$)	Securities Underlying Options/SARs (#)	LTIP Payouts (\$)	
Louis R. Woodhill Former President and Chief Executive Officer Worldwide Sales	2003	417,692		225,000(2)				
	2002	112,500	135,000					
	2001					400,000		—
Mark J. Cresswell (3) President and Chief Operating Officer Worldwide Sales	2003	300,000						
	2002	139,201						
	2001					200,000		
Brian D. Helman (4) Chief Financial Officer	2003	150,000				100,000		
	2002							
	2001							
Jonathan Reed Vice President of Product Development and Channel Sales Worldwide Sales	2003	186,000				20,300		
	2002	145,875	62,573					
	2001	115,000	69,944					
Chris Garner Vice President of Research and Development Worldwide Sales	2003	96,141	9,260			66,000		
	2002							
	2001							
Shelby R. Fike Vice President and General Counsel	2003	147,187	6,250			17,300		
	2002	109,971	21,204			20,000		
	2001							

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- (1) The compensation described in this table does not include medical, group life insurance or other benefits received by the Named Executive Officers that are available generally to all of our salaried employees, and may not include certain perquisites and other personal benefits received by the Named Executive Officers that do not exceed the lesser of \$50,000 or ten percent (10%) of any such officer's salary and bonus disclosed in the table.
- (2) Mr. Woodhill resigned as a director and as NEON's President and Chief Executive Officer on March 5, 2003. In connection with such resignation, Mr. Woodhill and NEON entered into a Separation Agreement securing certain transitional services from Mr. Woodhill, in addition to a full release of NEON. NEON paid Mr. Woodhill \$225,000 to secure such Separation Agreement and the Release.
- (3) Mr. Cresswell rejoined NEON in October 2001 at an annual salary of \$300,000. In addition, pursuant to the terms of his offer letter with NEON and as a condition to his acceptance of employment, NEON acquired Mr. Cresswell's interest in the assets of Lakeview Advisors Corporation (BVI) Limited, a company formed in the British Virgin Islands, of which Mr. Cresswell is a principal. Under such agreement, Mr. Cresswell will receive an aggregate amount of \$400,000 paid in equal quarterly payments of \$25,000 over a four-year period from October 2001 to September 30, 2005 as a result of this transaction. Such payments are being made to Lakeview Advisors Corporation (BVI) Limited pursuant to the terms of a promissory note dated March 29, 2002. As of July 29, 2003, NEON had paid Lakeview Advisors Corporation (BVI) Limited approximately \$157,500 of the aggregate amount of \$400,000.
- (4) In connection with Mr. Helman's relocation from Florida to Houston, NEON reimbursed \$49,424 in relocation expenses incurred by Mr. Helman. In addition, in the event that Mr. Helman is terminated for any reason other than voluntary resignation or for good cause, Mr. Helman will receive twelve (12) months of severance pay in a lump sum payment.

**Option Grants in Last Fiscal Year**

The following table sets forth each grant of stock options made during the fiscal year ended March 31, 2003 to the Named Executive Officers:

Name	Number of Securities Underlying  Options Granted	Percent of Total Options Granted to Employees in Fiscal Year (1)	Exercise or Base Price  (\$/Sh) (2)	Expiration  Date (3)	Potential Realizable Value At Assumed Annual Rates of Stock Price Appreciation For Option Term (4)	
					5% (\$)	10% (\$)
Louis R. Woodhill (5)		0.0%				
Mark J. Cresswell		0.0%				
Brian D. Helman (3)(6)	100,000	7.6%	\$ 3.94	07/02/12	247,784	627,935
Jonathan Reed (3)	20,300	1.5%	\$ 2.55	01/20/13	32,555	82,500
Shelby R. Fike (3)	17,300	1.2%	\$ 2.55	01/20/13	27,744	79,691
Chris Garner (3)	66,000	4.7%	\$ 3.27	10/16/12	135,728	343,961

- (1) Based on a total of 1,319,900 options granted during the fiscal year ended March 31, 2003. During the fiscal year ended March 31, 2003, 1,227,501 outstanding options were forfeited.
- (2) The option exercise price for the common stock is based on the fair market value on the date of grant as determined pursuant to the terms of the 1999 Long-Term Incentive Plan and 2002 Stock Plan.
- (3) Options granted have a ten-year term and vest over a four-year period with one-fourth of the options vesting one year from the date of grant and one forty-eighth of the options vesting each month thereafter. Options may terminate before their expiration date upon death, disability or termination of employment of the optionee.
- (4) In accordance with the rules of the Commission, shown are the gains or option spreads that would exist for the respective options granted. These gains are based on the assumed rates of annual compound stock price appreciation of 5% and 10% from the date the option was granted over the full option term. These assumed compound rates of stock price appreciation are mandated by the rules of the Commission and do not represent our estimate or projection of future prices of our common stock.
- (5) The options granted to Mr. Woodhill were granted on January 28, 2002, and vested over a four-year period with one fourth of the options vesting on October 15, 2002, and one forty-eighth of the options vesting each month thereafter. Mr. Woodhill resigned on March 5, 2003. Pursuant to the terms of the Separation Agreement between NEON and Mr. Woodhill, Mr. Woodhill was given two years until March 5, 2005, to exercise his 124,999 vested options. The remaining 275,001 unvested options expired and such shares were returned to the option pool.
- (6) In the event that NEON is acquired and within twelve (12) months of the acquisition Mr. Helman is terminated for any reason other than cause, including constructive termination, then all of Mr. Helman's unvested options will vest and become immediately exercisable.

**Aggregated Option Exercises in Last Fiscal Year and Fiscal Year End Option Values**

The following table sets forth, for each of the Named Executive Officers, information concerning the number of shares received during fiscal 2003 upon exercise of options and the aggregate dollar amount received from such exercise, as well as the number and value of securities underlying unexercised options held on March 31, 2003.

Shares Acquired On Exercise (#)	Value Realized (\$)	Number of Securities Underlying Unexercised Options at Fiscal Year-End (#)	Value of Unexercised In-the-Money Options at Fiscal Year-End (\$)
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<u>Name</u>	<u>Exercisable</u>	<u>Unexercisable</u>	<u>Exercisable</u>	<u>Unexercisable</u>
Louis R. Woodhill (2)	124,999			
Mark Cresswell (3)	62,499	137,501		
Brian D. Helman (3)		100,000		
Jonathan Reed (3)	14,605	20,300	\$ 20,393	
Chris Garner (3)		66,000		
Shelby R. Fike (3)	8,750	28,550		

- (1) Based on the difference between the option exercise price and the closing sale price of \$2.00 of our common stock as reported on the Nasdaq National Market on March 28, 2003, the last trading day of our 2002 fiscal year, multiplied by the number of shares underlying the options, no current options issued to executive officers are in the money options except as noted.
- (2) Mr. Woodhill resigned from the Company effective as of March 5, 2003. The Board of Directors has extended the period of time in which Mr. Woodhill may exercise his vested options to a termination date of March 31, 2005.
- (3) Options granted have a ten-year term and vest over a four-year period with one-fourth of the options vesting one year from the date of grant and one forty-eighth of the options vesting each month thereafter. Options may terminate before their expiration date upon death, disability or termination of employment of the optionee.

### Compensation of Directors

During fiscal 2003, each of our non-employee directors was monetarily compensated for serving as a member of our Board of Directors. Each of the non-employee directors received a fee of \$1,000 for each of the board meetings and committee meetings that they attended. In fiscal year 2003, the Board of Directors met 7 times, the Audit Committee met 5 times, the Compensation Committee met 5 times, and the Special Committee met 5 times.

In 1999 we adopted the Stock Option Plan for Non-Employee Directors for compensation of our non-employee directors and reserved 100,000 shares of our common stock for issuance thereunder. Under such plan, non-employee directors on the Board of Directors would be granted an option to purchase 7,500 shares of our common stock in connection with their respective appointments to our Board. The options granted under the Stock Option Plan for Non-Employee Directors vest equally in 33 1/3% increments on the date of each successive annual meeting during the three-year period following the date of grant.

At the annual meeting commenced on March 26, 2002 and reconvened on April 5, 2002, the 2002 Director Option Plan was approved by our stockholders to replace the Stock Option Plan for Non-Employee Directors. Each current non-employee director who was serving on the Board of Directors immediately following the Annual Meeting of Stockholders commenced on March 26, 2002 and who served on the Board of Directors in any of the last three fiscal years ended March 31, 2001, received a one-time initial Election option grant to purchase 12,500 shares of common stock for each of such three previous fiscal years, up to a maximum grant of 37,500 shares of common stock of NEON. Non-employee directors subsequently joining the Board of Directors, whether by appointment or election, will also receive a one-time initial Election option grant to purchase 12,500 shares of common stock under the 2002 Director Option Plan. On December 5, 2002, the Board expanded the Board of Directors from eight members to ten members and appointed David F. Cary and Loretta Cross as directors. On such date, the Board also authorized the issuance of an initial Election option grant to purchase 12,500 shares of common stock of NEON to Mr. Cary and Ms. Cross at an exercise price of \$2.50 per share.

Additionally, all non-employee directors serving on the Board of Directors of NEON immediately following any subsequent annual meeting of stockholders after the adoption of the 2002 Director Option Plan who have served as a director of NEON for at least the preceding six months will receive an Annual grant of an option to purchase 12,500 shares of common stock under the 2002 Director Option Plan. The Election options granted under the 2002 Director Option Plan vest equally in quarterly increments during the three-year period following the date of grant. The Annual options granted will vest equally in quarterly increments during a two-year period following the date of grant.

All stock options granted pursuant to the Stock Option Plan for Non-Employee Directors are nonqualified stock options and will remain exercisable for a period of ten years from the date of grant or, if sooner, six months after the option holder ceases to be a director of NEON. In the event of a change in control of NEON or certain other significant events, all options outstanding under the Stock Option Plan for Non-Employee Directors would



terminate, provided that immediately before the effective date of such transaction each holder of an outstanding option under the Stock Option Plan for Non-Employee Directors would be entitled to purchase the total number of shares of common stock that such option holder would have been entitled to purchase during the entire remaining term of the option.

All stock options granted pursuant to the 2002 Director Option Plan are and will be nonqualified stock options and will remain exercisable for a period of ten years from the date of grant. If a non-employee director's status as a director terminates for any reason (excluding death and disability), then all options held by him or her under the 2002 Director Option Plan will expire three months following the termination. If the non-employee director's status as a director terminates due to death or disability, then all options held by him or her under the 2002 Director Option Plan expire twelve months following the termination. In the event of any proposed dissolution or liquidation of NEON, any unexercised option would terminate immediately prior to the consummation of such proposed action. In the event of our merger or the sale of substantially all of our assets, each option may be assumed or an equivalent option substituted for by the successor corporation. If following such assumption or substitution a non-employee director's status as a director terminates other than by his or her voluntary resignation, the option will become fully vested and exercisable. If the successor corporation does not agree to assume or substitute for the option, each option will become fully vested and exercisable for a period of 30 days from the date our Board of Directors notifies the non-employee director of the option's full exercisability, after which the option will terminate.

#### **Compensation Committee Interlocks and Insider Participation**

Messrs. Moores, Noell, van den Berg, and Holcomb served on NEON's Compensation Committee during fiscal 2002 and are continuing to serve on that committee. These individuals currently do not serve as officers or employees of NEON. Mr. Moores served as interim Chief Executive Officer from June 2001 to October 15, 2001 during which time no Compensation Committee meetings were held. Other than Mr. Moores, none of these directors have served as officers or employees of NEON or any of its subsidiaries prior to or while serving on NEON's Compensation Committee. The following sets forth interlocks involving the executive officers and directors of NEON.

NEON interlocks with NEON Enterprise Software, Inc. (formerly Peregrine/Bridge Transfer Corporation and hereafter NESI). Mr. Noell and Mr. van den Berg serve as directors of NESI. Through his interest in Skunkware, Inc., Mr. Moores beneficially owns approximately 90% of NESI. Through their interests in Skunkware, Inc., each of Messrs. Noell and van den Berg beneficially own approximately 1% of NESI. See Certain Transactions Peregrine/Bridge Transfer Corporation.

NEON interlocks with Skunkware, Inc. Messrs. Noell, Moores and van den Berg serve as the directors of Skunkware, Inc., the sole stockholder of NESI. Mr. Moores beneficially owns approximately 90% of Skunkware, Inc. Each of Messrs. Noell and van den Berg beneficially own approximately 1% of Skunkware, Inc.

NEON interlocks with Scalable Software, Inc. On December 21, 2001, NEON announced that it had entered into a non-binding term sheet to be granted a two-year option to acquire Scalable Software, Inc., a privately held Houston-based provider of software asset lifecycle management tools for Windows networks. This term sheet reflected a revision by NEON and Scalable Software of NEON's previously announced plan to acquire Scalable Software. In addition, NEON also announced that Louis R. Woodhill, its then Chief Executive Officer, and Jim Woodhill had been appointed to the Board of Directors of NEON. On June 26, 2002, NEON entered into an Agreement and Plan of Merger, which documented the grant of the two-year option to acquire Scalable Software as outlined therein. Louis Woodhill is a founder of Scalable Software, Inc. and at that time both Louis and Jim Woodhill served on Scalable Software's Board of Directors, together with John J. Moores, Peter Schaeffer and Charles E. Noell, III. On January 20, 2003, Mr. Woodhill resigned as a director and as the President and Chief Executive Officer of Scalable Software. On March 6, 2003, Mr. Woodhill resigned from his position as President and Chief Executive Officer of NEON, as well as from his position as a director of NEON. In June 2003, Jim Woodhill resigned from his position as director of NEON.





**Item 12. Security Ownership of Certain Beneficial Owners and Management**

The percentage of shares owned provided in the table is based on 8,825,945 shares outstanding as of July 25, 2003. Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission and generally includes voting or investment power with respect to securities. Except as indicated by footnote, the persons named in the table have sole voting and investment power with respect to all shares of common stock shown as beneficially owned by them. The determination of whether these persons have sole voting and investment power is based on information provided by them. In computing an individual's beneficial ownership, the number of shares of common stock subject to options held by that individual that are exercisable within 60 days of July 25, 2003 are also deemed outstanding. These shares, however, are not deemed outstanding for the purpose of computing the beneficial ownership of any other person.

The following table sets forth certain information regarding beneficial ownership of our common stock as of July 25, 2003 by:

each of our directors;

Louis R. Woodhill, our former President and Chief Executive Officer, Mark J. Cresswell, our principal executive officer, and each of the four other most highly compensated individuals who served as our executive officers at fiscal year end;

all individuals who serve as directors or executive officers as a group; and

each person who is known by us to own beneficially more than 5% of our common stock.

Directors, Officers and 5% Stockholders	Shares Beneficially Owned	
	Number	Percent (1)
Louis R. Woodhill, former president and chief executive officer (2)	139,999	1.6%
Mark J. Cresswell, principal executive officer (3)	137,469	1.6%
Brian D. Helman, principal financial and accounting officer (4)	31,250	*
Jonathan Reed, Vice President of Product Marketing and Channel Sales (5)	87,355	*
Chris Garner, Vice President of Research and Development (6)	16,500	*
Shelby R. Fike, Vice President and General Counsel (7)	11,750	
John J. Moores, director (8)	3,673,092	42.0%
Charles E. Noell, director III (9)	299,619	3.4%
Norris van den Berg, director (10)	121,910	1.4%
James R. Woodhill, director (11)	98,510	1.1%
Peter Schaeffer, director (12)	362,668	4.1%
Richard Holcomb, director (13)	40,050	*
George H. Ellis, director (14)	21,041	*
David F. Cary, director (15)	3,125	*
Loretta Cross, director (16)	3,125	*
All executive officers and directors as a group (14 Persons) (17)	5,046,963	54.2%

\* Less than 1%

(1) The percentage of ownership calculations (other than as declared in footnote 17) are based on 8,825,945 shares issued and outstanding on July 25, 2003.

(2)

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- Includes 15,000 shares of common stock held by the Woodhill Foundation and 124,999 shares of common stock issuable upon exercise of outstanding stock options that are presently exercisable within 60 days of July 25, 2003.
- (3) Includes 137,469 shares of common stock issuable upon exercise of outstanding stock options that are presently exercisable within 60 days of July 25, 2003.
  - (4) Includes 31,250 shares of common stock issuable upon exercise of outstanding stock options that are presently exercisable or will become exercisable within 60 days of July 25, 2003.

- (5) Includes 87,355 shares of common stock issuable upon exercise of outstanding stock options that are presently exercisable within 60 days of July 25, 2003.
- (6) Includes 16,500 shares of common stock issuable upon exercise of outstanding stock options that are presently exercisable within 60 days of July 25, 2003.
- (7) Includes 11,250 shares of common stock issuable upon exercise of outstanding stock options that are presently exercisable or will become exercisable within 60 days of July 25, 2003.
- (8) Includes 3,646,842 shares of common stock owned by various family trusts for which Mr. Moores serves as trustee, as to which Mr. Moores disclaims beneficial ownership. Includes 10,000 shares of common stock owned by JMI Services, Inc. Also includes 26,250 shares of common stock issuable upon exercise of outstanding options that are presently exercisable or will become exercisable within 60 days of July 25, 2003. Mr. Moores address is c/o JMI, Inc., 12680 High Bluff Dr., Suite 200, San Diego, CA 92130.
- (9) Includes 273,369 shares of common stock and 26,250 shares of common stock issuable upon exercise of outstanding stock options that are presently exercisable or will become exercisable within 60 days of July 25, 2003.
- (10) Includes 95,660 shares of common stock and includes 26,250 shares of common stock issuable upon exercise of outstanding stock options that are presently exercisable or will become exercisable within 60 days of July 25, 2003.
- (11) Includes 15,000 shares of common stock held by the Woodhill Foundation, 11,685 shares held as trustee for a dependent and includes 5,625 shares of common stock issuable upon exercise of outstanding stock options that are presently exercisable or will become exercisable within 60 days of July 25, 2003.
- (12) Includes 354,335 shares of common stock and includes 8,333 shares of common stock issuable upon exercise of outstanding stock options that are presently exercisable or will become exercisable within 60 days of July 25, 2003.
- (13) Includes 40,050 shares of common stock issuable upon exercise of outstanding stock options that are presently exercisable or will become exercisable within 60 days of July 25, 2003.
- (14) Includes 21,041 shares of common stock issuable upon exercise of outstanding stock options that are presently exercisable or will become exercisable within 60 days of July 25, 2003.
- (15) Includes 3,125 shares of common stock issuable upon exercise of outstanding stock options that are presently exercisable or will become exercisable within 60 days of July 25, 2003.
- (16) Includes 3,125 shares of common stock issuable upon exercise of outstanding stock options that are presently exercisable or will become exercisable within 60 days of July 25, 2003.
- (17) The percentage of ownership calculation is based on 8,739,627 shares issued and outstanding, and 568,872 shares of common stock issuable upon exercise of outstanding stock options that are presently exercisable or will become exercisable within 60 days of July 25, 2003.

**Equity Compensation Plan Information**

This table sets forth the aggregate number of shares of common stock reserved for issuance under all of the compensation plans previously approved by the stockholders of NEON Systems, Inc. as of the end of March 31, 2003, including (a) the number of securities to be issued upon exercise of outstanding options, warrants and rights, (b) the weighted-average exercise price of outstanding options, warrants and rights and (c) the number of securities remaining available for future issuance under equity compensation plans excluding item (a). There are no compensation plans that have not been previously approved by the stockholders of NEON Systems, Inc.

**Equity Compensation Plan Information**

<u>Plan category</u>	<u>(a)</u> <b>Number of securities to be issued upon exercise of outstanding options, warrants and rights</b>	<u>(b)</u> <b>Weighted-average exercise price of outstanding options, warrants and rights</b>	<u>(c)</u> <b>Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column(a)(1))</b>
Equity compensation plans approved by security holders	2,957,919	\$ 6.7068	1,969,626
Equity compensation plans not approved by security holders	-0-	-0-	-0-
<b>Total</b>	<b>2,957,919</b>	<b>\$ 6.7068</b>	<b>1,969,626</b>

- (1) The 2002 Stock Plan provides for an annual increase on the first day of each fiscal year, beginning April 1, 2003, equal to the lesser of (i) 750,000 shares of NEON common stock, (ii) 5% of the outstanding shares of NEON common stock on such date, or (iii) a lesser amount determined by the Board of Directors. The 2002 Director Plan provides for an annual increase on the first day of each fiscal year, beginning April 1, 2003, equal to the lesser of (i) 2% of the outstanding shares of NEON common stock on such date, or (ii) a lesser amount determined by the Board of Directors.

**Employee Stock Option Plans**

Under the 1993 Stock Plan (1993 Plan) for the officers and employees of NEON, the Board of Directors authorized the grant of non-qualified incentive stock options to purchase up to 2.6 million shares of NEON's Common Stock. Such options become exercisable either on the date of grant or in such installments as the grant may specify up to 10 years from the date of grant.

In January 1999, NEON adopted the 1999 Long-Term Incentive Plan (1999 Plan) that provides for the grant of incentive stock options and non-qualified stock options to purchase NEON common stock, stock appreciation rights, restricted stock and performance units, to key employees of NEON. NEON reserved 2.0 million shares of its common stock for issuance under the 1999 Plan. In connection with NEON's adoption of the 1999 Plan, NEON has not made any new grants under the 1993 Plan and options previously issued under the 1993 Plan are exercisable in accordance with their terms.

In January 1999, NEON adopted the Stock Option Plan for Non-Employee Directors for compensation of its outside directors and reserved 100,000 shares of its common stock for issuance thereunder. Outside directors joining the Board of Directors were to receive options to purchase 8,000 shares of NEON common stock exercisable at the fair market value of the common stock at the close of business on the date immediately preceding the date of grant (the initial outside directors will be eligible for such grants upon their re-election to the Board of Directors). These annual options would vest equally in 33 1/3% increments over the three-year period from the date of grant. All stock options granted pursuant to the Stock Option Plan for Non-Employee Directors were to be nonqualified stock options and remain exercisable for a period of ten years from

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the date of grant or, if earlier, six months after the option holder ceases to be a director of NEON. In the event of a change in control of NEON or certain other significant events, all options outstanding under the Stock Option Plan for Non-Employee Directors would terminate, provided that immediately before the effective date of such transaction each holder of

an outstanding option under the Stock Option Plan for Non-Employee Directors shall be entitled to purchase the total number of shares of common stock that such option holder would have been entitled to purchase during the entire remaining term of the option.

On January 28, 2002, the Board of Directors adopted the 2002 Stock Plan, and reserved 2.0 million shares of NEON common stock for issuance under the 2002 Stock Plan plus (a) any shares of NEON common stock that had been reserved but not issued under our 1999 Long-Term Incentive Plan as of the date of stockholder approval of the 2002 Stock Plan, (b) any shares of NEON common stock returned to the 1999 Long-Term Incentive Plan as a result of termination of options or repurchase of shares of NEON common stock issued under the 1999 Long-Term Incentive Plan and (c) annual increases on the first day of each fiscal year, beginning April 1, 2003, equal to the lesser of (i) 750,000 shares of NEON common stock, (ii) 5% of the outstanding shares of NEON common stock on such date or (iii) a lesser amount determined by our Board of Directors. The 2002 Stock Plan replaces the 1999 Long-Term Incentive Plan. On March 26, 2002, the stockholders of NEON approved the 2002 Stock Plan at NEON's Annual Meeting of Stockholders. As of March 31, 2003, the total outstanding stock options for the 2002 Stock Plan were 852,000. On April 1, 2003, the total shares available for issuance under the 2002 Stock Plan was increased 441,069, which was 5% of the total outstanding shares of NEON common stock on April 1, 2003.

On January 28, 2002, the Board of Directors adopted the 2002 Director Option Plan. The 2002 Director Option Plan is intended to replace the Stock Option Plan for Non-Employee Directors, which the Board of Directors terminated after approval of the 2002 Director Option Plan. The Board of Directors has reserved a maximum of 250,000 shares of NEON common stock for issuance under the 2002 Director Option Plan plus (a) any shares of NEON common stock which had been reserved but not issued under the Stock Option Plan for Non-Employee Directors as of the date of stockholder approval of the 2002 Director Option Plan, (b) any shares of NEON common stock returned to the Stock Option Plan for Non-Employee Directors as a result of termination of options or repurchase of shares issued under the Stock Option Plan for Non-Employee Directors, and (c) annual increases on the first day of each fiscal year, beginning on April 1, 2003, equal to the lesser of (i) 2% of the outstanding shares of NEON common stock on such date or (ii) an amount determined by our Board of Directors. On March 26, 2002, the stockholders of NEON approved the 2002 Director Option Plan at the NEON Annual Meeting of Stockholders. At the conclusion of the Annual Meeting on March 26, 2002, options to purchase 187,500 of the available 305,000 share option pool were issued as initial options to Non-Employee Directors who had served in any of the previous three fiscal years. On December 8, 2002, David F. Cary and Loretta Cross were appointed independent directors to NEON's Board of Directors. In connection with such appointment, they were granted 12,500 initial options under the 2002 Director Option Plan. At the conclusion of the Annual Meeting of Stockholders on February 4, 2003, options to purchase 87,500 of the available 92,500 share option pool were issued as annual options to Non-Employee Directors who had served as such during the prior six-month period. On April 1, 2003, the number of shares available for issuance under the 2002 Director Option Plan was increased by 176,428 shares of NEON common stock (2% of the outstanding shares of NEON common stock on April 1, 2003).

### **Item 13. *Certain Relationships and Related Transactions***

#### **Certain Transactions**

Members of NEON's Board of Directors and certain executive officers of NEON are shareholders and/or directors in other companies with which NEON has business relationships. Transactions between NEON and these other companies are described below.

#### *NEON Enterprise Software, Inc. (formerly Peregrine/Bridge Transfer Corporation)*

In January 1996, NEON entered into a distribution agreement with Peregrine/Bridge Transfer Corporation, a database software company whose sole stockholder is an affiliate of John J. Moores, NEON's Chairman of the



Board of Directors. PBTC subsequently changed its name to NEON Enterprise Software, Inc. ( NESI ). The distribution agreement had an initial term through January 1, 1998 and could be automatically renewed for successive one-year terms. The agreement also provided that NEON pay royalties to NESI for the license of products and for maintenance and support and upgrade services equal to 50% of the revenues received by NEON for NEON s distribution of NESI s only products, its Enterprise Subsystem Management products (referred to elsewhere as the ESM products). NEON also entered into a services agreement with NESI pursuant to which NESI reimbursed NEON for NESI s share of the general and administrative expenses supplied to it by NEON. Such amounts have historically been presented as a reduction of general and administrative expenses in the accompanying consolidated financial statements. NEON revised the services agreement with NESI in October 2001, as a result of which NESI s monthly payment to NEON declined from \$30,000 per month to \$5,000 per month and NEON s services were reduced. In December 1998, NEON amended its distribution agreement with NESI and NESI granted NEON an exclusive, worldwide license to market and sublicense NESI s ESM products in exchange for NEON s agreement to extend the term of the agreement through March 31, 2004 and pay NESI a minimum advance royalty of \$250,000 per quarter during fiscal year 2000, \$500,000 per quarter during fiscal year 2001, \$750,000 per quarter during fiscal year 2002, \$1.0 million per quarter during fiscal year 2003, and \$1.3 million per quarter during fiscal year 2004, for an aggregate payment of \$15 million. Such advance royalty payments have historically been recorded by NEON as a prepaid expense and offset by 50% of NEON s sales of ESM products. The amended distribution agreement also provided that NESI would reimburse NEON for the amount of any unearned royalty advances when the agreement terminated in 2004.

On June 30, 2002, the balance of the unearned advance payments was \$3.0 million, an increase of \$822,000 from March 31, 2002. Management believed that while the then-current and reasonably foreseeable business prospects for revenue received by NEON from licenses and maintenance for ESM products was expected to be sufficient to offset the unearned advance royalty payments as of June 30, 2002, these revenues did not appear to be sufficient to meet the aggregate future minimum royalties required to be paid by NEON to NESI over the term of the distribution agreement. As a result, the balance of unearned advance royalty payments was projected to increase substantially by the time the distribution agreement would terminate on March 31, 2004. On June 30, 2002, NESI s sole source of income was the royalty payments made by NEON and NESI had a substantial negative net worth. As a result, NEON s Board had concerns regarding NESI s ability to repay any balance of unearned advances at the termination of the agreement in 2004.

On July 2, 2002, the independent directors of NEON authorized the officers of NEON to review the distributor relationship with NESI and to negotiate a termination of the distribution agreement. On July 24, 2002, the independent directors of NEON approved a letter of intent with proposed terms for a termination of the distribution agreement, which letter of intent was executed by NESI and NEON on such date. Pursuant to the provisions of the letter of intent and after the review and approval of the independent directors of NEON and the ratification by the full Board of Directors on August 12, 2002, NEON and NESI entered into a Termination and Customer Support Agreement dated August 14, 2002 pursuant to which the distribution agreement, the services agreement, and all other agreements between NEON and NESI were terminated effective as of August 1, 2002.

Upon the closing of the Termination and Customer Support Agreement on August 14, 2002, NESI s right to receive from NEON, and NEON s corresponding obligation to pay to NESI, the advance royalty payments described in the distribution agreement terminated. Additionally, NEON s option to purchase NESI and right of first refusal under the distribution agreement also terminated. The Termination and Customer Support Agreement provides that, in consideration of NESI s consent to terminate its existing agreements with NEON, NEON paid NESI a final cash advance of \$2.2 million, which amount has been consolidated with \$884,000 of the outstanding unearned royalty advance under the distribution agreement as of July 31, 2002 and the \$500,000 payment with respect to the transfer of rights described below and represented by the consolidated promissory note payable to NEON in the aggregate principal amount of \$3.6 million, bearing no interest to its due date of March 31, 2005. This consolidated promissory note is secured by all of the intellectual property of NESI ( NESI IP ). The Termination and Customer Support Agreement also provided that the remaining outstanding unearned royalty advance of \$3.0 million as of July 31, 2002 was converted into a \$3.0 million dollar convertible promissory note



payable to NEON bearing no interest to its due date of March 31, 2005, which is also secured by the NESI IP. The \$3.0 million convertible note is convertible by NEON, in its discretion, into equity in NESI at an agreed pre-cash valuation of \$30.0 million dollars. Such conversion right will expire on the due date of the \$3.0 million convertible note. Upon closing, NEON recorded the notes receivable from NESI at their estimated net present value, which was calculated at \$4.3 million in aggregate. As a result of the termination agreement, NEON recorded a loss on disposal of \$687,000. NEON also evaluates the NESI IP on a quarterly basis to determine the note's net realizable value, as it is secured by the NESI IP. Accordingly, NEON will adjust the carrying value of the note if the net realizable value is determined to be below the carrying value. After March 31, 2003, NEON management had an external valuation of the NESI IP performed and determined that no further impairment of the note was required.

Pursuant to the Termination and Customer Support Agreement and an assignment executed in connection with the closing of the Termination and Customer Support Agreement and effective as of August 1, 2002, NESI was assigned all of NEON's rights and obligations under any customer license and maintenance agreements related to the ESM software products previously marketed by NEON, including customer support obligations. In addition, the terms of the Termination and Customer Support Agreement provide that NESI offered employment to certain sales and support personnel of NEON that were assigned to market the NESI software products. The Termination and Customer Support Agreement also contemplated the resignation of Wayne E. Webb Jr. as Senior Vice President and General Counsel of NEON effective as of August 1, 2002 to focus on his role as President and CEO of NESI.

At the closing of the Termination and Customer Support Agreement, Skunkware, Inc., NESI's sole stockholder, entered into a Subordination Agreement whereby all of the promissory notes described above from NESI to NEON were made senior in priority to all other indebtedness from NESI to Skunkware. Pursuant to the terms of the convertible promissory note and the consolidated promissory note, NESI has agreed to preserve and maintain the senior status of its indebtedness to NEON and pursuant to the Security Agreement agreed to not issue any additional debt unless such debt does not encumber the NESI IP.

In further consideration of NESI entering into the Termination and Customer Support Agreement, NEON agreed to provide NESI with administrative, accounting and legal services pursuant to the terms of a new services agreement. Such services will be provided by NEON at no cost to NESI, other than reimbursement of reasonable business expenses, for the twelve-month period beginning August 1, 2002. After the initial twelve-month period of the services agreement, NESI may elect to receive the services, at its option, for up to an additional twelve months for a fee of \$10,000 per month. At the end of such additional term, or in the event NESI does not elect to continue receiving the services described above for the additional term, at the end of the initial term, NEON shall have no further obligations under the services agreement.

Additionally, in connection with the closing of the Termination and Customer Support Agreement on August 14, 2002, NEON and NESI entered into a license and distribution agreement whereby NESI agreed to market and distribute NEON's 24x7 software product. The NEON 24x7 software product was developed by NESI as an OEM software product using the Shadow source and object code under a remarketing agreement dated January 25, 2000. This remarketing agreement provided that NEON would distribute the NEON 24x7 software product under the terms of the distributor agreement.

Finally, in connection with the closing of the Termination and Customer Support Agreement on August 14, 2002, NEON and NESI entered into a trademark license agreement granting NESI a license to use the NEON<sup>®</sup> registered trademark in its marketing of NEON 24x7 and the NESI software products. Under the terms of this agreement, NEON granted NESI the option to acquire the NEON<sup>®</sup> trademarks in the event that NEON discontinues its use of such marks.

**Scalable Software, Inc.**

Scalable Software, Inc., a Houston-based provider of software solutions for IT portfolio management, is a company founded by Louis R. Woodhill, who served as NEON's Chief Executive Officer until March 2003. Several current and former members of NEON's Board of Directors, including Louis R. Woodhill, John J. Moores, Peter Schaeffer, Charles E. Noell III and Jim Woodhill, have a financial interest in Scalable Software. The percentage beneficial ownership of the current and former NEON directors and executive officers that have a financial interest in Scalable Software as of March 31, 2003 is set forth below:

<u>Name</u>	<u>Ownership Percentage</u>
Jim Woodhill (former NEON director)	24%
John J. Moores (and affiliates)	24%
Louis R. Woodhill (former NEON CEO)	17%
Charles E. Noell III (and affiliates)	15%
Peter Schaeffer	2%
<b>Total</b>	<b>82%</b>

On July 17, 2001, NEON announced that it had entered into a letter of intent to acquire Scalable Software, Inc. At that time, Louis R. Woodhill, then Chief Executive Officer of NEON, was also a director, and the President and Chief Executive Officer of Scalable Software. In connection with the letter of intent, NEON and Scalable Software entered into a Promissory Note dated July 17, 2001, which provided bridge financing to Scalable in a maximum amount of \$3.0 million with a maturity date of December 31, 2001, secured by the personal guarantees of John J. Moores, Louis R. Woodhill and Jim Woodhill. On October 17, 2001, Mr. Woodhill was asked to serve as the President and Chief Executive Officer of NEON. On November 13, 2001, the promissory note was amended to increase the maximum lending limit to \$3.5 million with an original maturity date of March 31, 2002, with such increased amount also being guaranteed by Messrs. Moores, Woodhill and Woodhill. On December 21, 2001, Mr. Woodhill and his twin brother Jim Woodhill, were asked to join the Board of Directors of NEON.

Due to the interests in Scalable Software of several members of NEON's Board of Directors, the Board of Directors concluded that it would be appropriate to create a Special Committee comprised solely of independent directors who had no interest in Scalable Software to review the terms of the proposed acquisition. After thorough consideration and discussion and upon endorsement by the Special Committee, NEON's Board of Directors approved modifications to the proposed terms and conditions for the acquisition such that the transaction would be structured as an option to acquire Scalable Software as discussed below.

NEON obtained a two-year option to acquire Scalable Software as outlined in the Agreement and Plan of Merger dated June 26, 2002. In connection with this Option, NEON agreed to provide bridge financing of up to \$5.5 million, in addition to the \$3.5 million previously loaned to Scalable Software that is secured by personal guarantees from John J. Moores, Louis R. Woodhill and Jim Woodhill. The aggregate financing had a 36-month term and does not bear interest during the term of the two-year option to acquire Scalable Software. After the expiration of the option, the loan will bear interest at the prime rate plus two percentage points. In addition to the personal guarantees of John J. Moores, Louis R. Woodhill and Jim Woodhill for the initial \$3.5 million loaned to Scalable Software, the \$5.5 million loan will be secured by all of the intellectual property rights of Scalable Software. NEON may exercise the option to acquire Scalable Software at any time during the two-year term, subject to provisions that require NEON to exercise its option within a 30-day window under certain circumstances or forfeit the option. If NEON exercises the option and acquires Scalable Software, each of the approximately 19.4 million outstanding shares of common stock of Scalable Software will be converted into approximately 0.135 of a share of NEON common stock and outstanding options and warrants to purchase approximately 3.0 million shares of common stock of Scalable Software will become options and warrants to purchase common stock of NEON on the same conversion basis. If Scalable Software incurs more indebtedness



for borrowed money or issues more equity, the exchange ratio will be adjusted accordingly. Prior to NEON exercising the option to acquire Scalable Software, a Special Committee would be appointed to review the negotiated terms of the proposed acquisition and NEON would seek to obtain a fairness opinion regarding the transaction from a financial advisory firm. The acquisition of Scalable Software will also require approval of the stockholders of NEON and the NEON Board of Directors.

On October 16, 2002, the Board of Directors reviewed the progress of Scalable Software with respect to the timing of its anticipated break-even quarter and determined that Scalable Software may require an additional infusion of at least \$500,000 in additional capital to meet its projections. In the interest of preserving NEON's investment, the Special Committee approved an increase in the aggregate borrowing limit under the \$5.5 million loan to an aggregate principal amount of \$6.0 million, an increase of \$500,000 in Scalable Software's aggregate borrowing limits under its line of credit with NEON. Such increase was memorialized in an amendment to the relevant promissory notes and security agreements on December 23, 2002, and is subject in all respect to the current terms and conditions of the \$5.5 million loan. It has previously been management's belief that Scalable Software may exhaust its line of credit from NEON before it is able to generate cash from operations sufficient to sustain its operations. As of the date of this filing, Scalable has exhausted its credit facility with NEON. Scalable has asked for and received waivers of NEON's right of first refusal with respect to additional venture capital bridge financing from JMI Services, Inc. and is currently pursuing a private placement of Convertible Preferred Stock. If Scalable Software is unable to secure such additional financing, it is management's belief that Scalable Software could become the subject of bankruptcy proceedings. If Scalable Software is subject to bankruptcy proceedings, it is possible that the security interests held by NEON in the intellectual property of Scalable Software might be set aside, and in such event NEON could be treated as an unsecured creditor with respect to the \$6.0 million loan.

As noted above, certain current and former members of NEON's board of directors and executive officers also serve as directors and executive officers of Scalable Software and claim beneficial ownership of approximately 82% of Scalable's common stock. In addition, NEON has an option to acquire all of the outstanding shares of Scalable Software and is Scalable's primary creditor. Therefore, NEON determined that it had effective control of Scalable Software while it was advancing funds to Scalable and accounted for its investment in Scalable Software using the modified equity method of accounting. Under this method of accounting, NEON recognized 100% of Scalable Software's losses to the extent of advances made in excess of the guaranteed amount. At March 31, 2003, NEON had made total advances of \$9.5 million to Scalable Software (including \$6.0 million of unguaranteed advances) and recognized cumulative losses of \$5.6 million, of which \$3.5 million were recorded during fiscal 2003. As NEON does not currently intend to advance any additional funds to Scalable at this time, we do not currently foresee the recognition of any additional losses attributable to Scalable Software. Due to the uncertainties regarding NEON's ultimate ability to recover any unguaranteed advances to Scalable Software, NEON has decided to not record the carrying value of its net advance to Scalable Software above the guaranteed amount. Accordingly, for fiscal 2003, NEON recorded a valuation allowance of \$378,000 against the Scalable note receivable, reducing the carrying value of the note receivable to the \$3.5 million guaranteed amount.

*Sheer Genius Software, Inc.*

On January 3, 2002, NEON entered into a services agreement with Sheer Genius Software, Inc. of Austin, Texas, a company owned by Jim Woodhill. Jim Woodhill was a member of NEON's Board of Directors at such time. Also, JMI Services, Inc., a private company owned by John J. Moores, NEON's Chairman, is a creditor of Sheer Genius. Under the first project description negotiated for such services agreement, Sheer Genius provided development services to NEON on a budgeted time and materials basis and delivered fixed deliverables consisting primarily of developed source code. The term of the initial project description was six months and the aggregate fees were \$480,000. This agreement was extended by the Board for an additional three months with additional aggregate fees of \$300,000. On October 16, 2002, the Board determined that the Services Agreement with Sheer Genius should be extended on a month-to-month basis. On May 20, 2003, NEON terminated the Agreement with Sheer Genius and will continue such development efforts internally. All fees under the arrangement were expensed as incurred and included in research and development. While NEON was Sheer

Genius sole source of income, it was free to solicit other customers. Under the services agreement, all intellectual property created by Sheer Genius in the course of performing the services is owned by NEON. Sheer Genius received a license back of such intellectual property for limited use in the development by Sheer Genius of software that does not compete with software distributed by NEON. The Board of Directors reviewed the terms of the services agreement and project description and approved such agreements following disclosure of the interest of its officers and directors associated with Sheer Genius. For the year ended March 31, 2003, NEON paid \$900,000 to Sheer Genius Software for services fees. As of the date of termination of the Services agreement with Sheer Genius, NEON had paid services fees in aggregate of \$1.3 million.

*Other Directorships*

Members of our Board of Directors also serve as officers or directors of other software or computing companies. NEON and such companies, despite each being software companies, are not sufficiently similar in their operations to be competitors. We do not believe that the concurrent service of our directors as officers and/or directors of the entities listed in their biographical descriptions poses potential conflicts of interest.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) 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.

NEON SYSTEMS, INC.

By: /s/ MARK CRESSWELL

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**Mark Cresswell**

**President and Chief Operating  
Officer**

**(principal executive officer)**

Date: July 29, 2003

<b>Exhibit Number</b>	<b>Description</b>
31	Certification of Mark Cresswell, principal executive officer on NEON Systems, Inc. pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  Certification of Brian D. Helman, principal financial and accounting officer of NEON Systems, Inc. pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification of Mark Cresswell, principal executive officer on NEON Systems, Inc. pursuant to 18 U.S.C. SECTION 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.  Certification of Brian D. Helman, principal financial and accounting officer of NEON Systems, Inc. pursuant to 18 U.S.C. SECTION 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.