

ELOYALTY CORP
Form S-3/A
November 13, 2001

Table of Contents

As filed with the Securities and Exchange Commission on November 13, 2001

Registration No. 333-70078

U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Amendment No. 1

to

Form S-3

REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

eLoyalty Corporation

(Exact name of registrant as specified in its charter)

Delaware 36-4304577 *(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)*

150 Field Drive, Suite 250

**Lake Forest, Illinois 60045
(847) 582-7000**

(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)

Kelly D. Conway

President and Chief Executive Officer

**eLoyalty Corporation
150 Field Drive, Suite 250
Lake Forest, Illinois 60045
(847) 582-7000**

(Name, address, including zip code, and telephone number, including area code, of agent for service)

Copies to:

**Robert S. Wert
Vice President and General Counsel
eLoyalty Corporation
150 Field Drive, Suite 250
Lake Forest, Illinois 60045
(847) 582-7000
Bruce F. Perce
Mayer, Brown & Platt
190 South LaSalle Street
Chicago, Illinois 60603-3441
(312) 782-0600**

Approximate date of commencement of proposed sale to the public: As soon as practicable after the effective date of this registration statement.

Edgar Filing: ELOYALTY CORP - Form S-3/A

If the only securities being registered on this Form are being offered pursuant to dividend or interest reinvestment plans, please check the following box.

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, check the following box.

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.

If delivery of the prospectus is expected to be made pursuant to Rule 434, check the following box.

We hereby amend this registration statement on such date or dates as may be necessary to delay its effective date until we file a further amendment which specifically states that this registration statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the registration statement shall become effective on such date as the Securities and Exchange Commission, acting pursuant to said Section 8(a), may determine.

The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

TABLE OF CONTENTS

TABLE OF CONTENTS

DOCUMENTS INCORPORATED BY REFERENCE

WHERE YOU CAN FIND MORE INFORMATION

QUESTIONS AND ANSWERS ABOUT THE RIGHTS OFFERING

PROSPECTUS SUMMARY

RISK FACTORS

FORWARD-LOOKING STATEMENTS

USE OF PROCEEDS

PRICE RANGE OF OUR COMMON STOCK

DETERMINATION OF OFFERING PRICE

CAPITALIZATION

THE RIGHTS OFFERING

DESCRIPTION OF THE SERIES B CONVERTIBLE PREFERRED STOCK

DESCRIPTION OF THE CAPITAL STOCK

MATERIAL U.S. FEDERAL INCOME TAX CONSEQUENCES

PLAN OF DISTRIBUTION

LEGAL MATTERS

EXPERTS

RESOLUTION OF THE BOARD OF DIRECTORS APPROVING THE DESIGNATION STATEMENT

RELATING TO 7% SERIES B CONVERTIBLE PREFERRED STOCK

SIGNATURES

EXHIBIT INDEX

Form of Rights Certificate

Specimen Certificate

Opinion of Mayer, Brown & Platt

Statement of Computation of Ratios

Consent of PricewaterhouseCoopers LLP

Form of Instructions

Form of Letter to Stockholders of Record

Form of Letter to Securities Brokers, Dealers, ect

Form of Letter to Clients and Instructions

Form of Subscription Agent Agreement

Table of Contents

Subject to Completion, dated November 13, 2001

PROSPECTUS

7% Series B Convertible Preferred Stock

Issuable Upon Exercise of Subscription Rights

We are distributing rights to purchase shares of 7% Series B convertible preferred stock on a pro rata basis to all holders of record of our common stock on October 8, 2001. Each share of preferred stock will accrue dividends at a rate of 7% per annum and will be convertible into one share of our common stock beginning six months after the closing of the rights offering.

We are also selling shares of Series B preferred stock at the same price to two of our existing stockholders in a concurrent private placement of up to \$25.0 million. The investors in the private placement will not exercise their rights in the rights offering.

You have been granted one right for each share of common stock you held on the record date. If you exercise your rights, the number of preferred shares that you will be eligible to purchase will be determined at the closing of the rights offering. You will be able to maintain up to your approximate ownership percentage in eLoyalty after taking into account the rights offering and the private placement.

Each right entitles you to subscribe for, at your option, \$1.60, \$1.00 or \$0.50 of preferred stock. The purchase price per share of preferred stock will be the lesser of \$0.51 and 90% of the average of the last sale price of our common stock over the twenty trading days through and including the fourth trading day prior to the closing date of this rights offering, subject to adjustment for a proposed one-for-ten reverse split of our common stock. We will make a public announcement of the purchase price following the close of trading on the fourth trading day prior to the closing date of the rights offering. Our common stock is traded on the Nasdaq National Market under the symbol ELOY. On November 12, 2001, the last sale price of our common stock was \$0.51 per share.

You may exercise some or all of your rights, or you may choose not to exercise any of your rights. However, for each right you exercise you must own at least one pre-split share of our common stock on the closing date.

You may not increase your ownership percentage through the exercise of rights. As a result, the maximum number of shares that you may purchase may be less than the amount you subscribe for, in which case the subscription agent will return the unused portion of your subscription payment, plus interest accruing after the closing date, promptly following the closing of the rights offering.

You must exercise your rights before they expire at 5:00 p.m. New York City time on December 19, 2001, unless we extend the offering, by completing a rights certificate and delivering it with payment of the subscription price to the subscription agent.

You may not sell or transfer your rights. In addition, the preferred stock may not be transferred until one year after the closing of the rights offering. We do not intend to list the rights or the preferred stock on any securities exchange or include them in any automated quotation system.

The exercise of rights involves substantial risk. Before exercising your rights you should read the discussion of material risks under Risk Factors beginning on page 20.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

	Purchase Price	Proceeds to eLoyalty(1)
Per share of preferred stock(2)	\$0.51	\$0.51
Total(3)		
\$61,991,057 \$61,991,057		

Edgar Filing: ELOYALTY CORP - Form S-3/A

- (1) Before deducting expenses payable by us, estimated to be approximately \$1,000,000.
- (2) The purchase price per share will be the lesser of \$0.51 and 90% of the average of the last sale price of our common stock over the twenty trading days through and including the fourth trading day prior to the closing date of the rights offering, subject to adjustment for a proposed one-for-ten reverse split of our common stock.
- (3) Assuming all of the rights are exercised for \$1.60 of preferred stock per right. The proceeds to us will be less if less than all of the rights are exercised or if rights are exercised for less than \$1.60 of preferred stock per right.

The date of this prospectus is _____, 2001

Table of Contents

TABLE OF CONTENTS

Documents Incorporated by Reference	
i	
Where You Can Find More Information	
ii	
Questions and Answers about the Rights Offering	
1	
Prospectus Summary	
9	
Risk Factors	
20	
Forward-Looking Statements	
33	
Use of Proceeds	
34	
Price Range of Our Common Stock	
34	
Determination of Offering Price	
35	
Capitalization	
36	
The Rights Offering	
38	
Description of the Series B Convertible Preferred Stock	
51	
Description of the Capital Stock	
55	
Material U.S. Federal Income Tax Consequences	
59	
Plan of Distribution	
60	
Legal Matters	
61	
Experts	
61	
Annex A Certificate of Designations of Series B Convertible Preferred Stock	
A-1	

DOCUMENTS INCORPORATED BY REFERENCE

The Securities and Exchange Commission allows us to incorporate by reference certain documents, which means that we can disclose important information to you by referring you to those documents. The information in the documents incorporated by reference is considered to be part of this prospectus, except to the extent that this prospectus updates or supersedes the information. We incorporate by reference the documents listed below which we have previously filed with the SEC:

1. our Annual Report on Form 10-K for the fiscal year ended December 30, 2000, including the portions incorporated by reference from our proxy statement in connection with our 2001 annual meeting of stockholders;
2. our Quarterly Reports on Form 10-Q for the quarters ended March 31, 2001, June 30, 2001 and September 29, 2001;
3. our Current Report on Form 8-K filed on September 25, 2001; and
4. the description of our common stock contained in our Registration Statement on Form 8-A, including any amendments or reports filed for the purpose of updating this description.

Edgar Filing: ELOYALTY CORP - Form S-3/A

We also incorporate by reference the information contained in all other documents we file with the SEC under Sections 13(a), 13(c), 14 and 15(d) of the Securities Exchange Act of 1934 after the date of this prospectus and prior to the completion of the rights offering. The information will be considered part of this prospectus from the date the document is filed and will supplement or amend the information contained in this prospectus.

We will provide you, at no charge, a copy of the documents we incorporate by reference in this prospectus. **To obtain timely delivery, requests for copies should be made no later than December 12, 2001 (five business days before the scheduled expiration of the rights offering).**

Table of Contents

To request a copy of any or all of these documents, you should write or telephone us at the following address and telephone number:

eLoyalty Corporation
150 Field Drive, Suite 250
Lake Forest, Illinois 60045
Attn: Investor Relations
(847) 582-7000

WHERE YOU CAN FIND MORE INFORMATION

We file annual, quarterly and special reports, proxy statements and other documents with the SEC under the Securities Exchange Act of 1934. The Exchange Act file number for our SEC filings is 0-27975. Our SEC filings made electronically through the SEC's EDGAR system are available to the public at the SEC's web site at <http://www.sec.gov>. You may also read and copy any document we file with the SEC at the SEC public reference room at Judiciary Plaza, 450 Fifth Street, N.W., Washington, D.C. 20549. You may obtain information regarding the operation of the SEC's public reference room by calling the SEC at 1-800-SEC-0330.

We have filed with the SEC a Registration Statement on Form S-3 under the Securities Act of 1933, and the rules and regulations promulgated thereunder, with respect to this rights offering. This prospectus, which constitutes part of the registration statement, does not contain all of the information set forth in the registration statement and the attached exhibits and schedules. The statements contained in this prospectus as to the contents of any contract, agreement or other document that is filed as an exhibit to the registration statement are not necessarily complete. Accordingly, each such statement is qualified in all respects by reference to the full text of such contract, agreement or document filed as an exhibit to the registration statement or otherwise filed with the SEC.

You should rely only on the information contained or incorporated by reference in this prospectus. We have not authorized anyone to provide you with information different from that contained in this prospectus. This prospectus is not an offer to sell or a solicitation of an offer to buy any securities in any state or other jurisdiction in which the offer or solicitation is not permitted. You should not assume that the information in this prospectus is accurate as of any date other than the date of this prospectus.

eLoyalty is a trademark of eLoyalty Corporation. This prospectus also includes or incorporates by reference other trademarks of ours or of other companies.

Table of Contents

QUESTIONS AND ANSWERS ABOUT THE RIGHTS OFFERING

The information in this prospectus assumes a purchase price of \$0.51 per share of preferred stock in the rights offering and private placement and gives effect to the issuance of approximately 5.7 million shares of common stock in exchange for outstanding employee stock options in connection with a recently completed exchange offer. It does not give effect to a proposed one-for-ten reverse split of our common stock that we expect to occur shortly before closing. We have made other assumptions as well which are described under Prospectus Summary Other Information.

What is a rights offering?

A rights offering is a distribution of rights on a pro rata basis to all of our stockholders. We are distributing one right for each share of our common stock you held at the close of business on October 8, 2001, the record date for the rights offering.

As a result of the tax restrictions described below, the investors in the private placement cannot exercise their rights. In addition, as a result of these restrictions rights issued in respect of restricted stock issued to some of our officers and employees that has not vested prior to the closing date cannot be exercised. As a result, the information in this prospectus regarding the amount and percentage of rights exercised is based on the amount and percentage of rights that are eligible to be exercised and excludes rights that cannot be exercised.

What is a right?

Each right entitles you to subscribe to purchase shares of Series B convertible preferred stock. To exercise your rights, you must specify the maximum dollar amount of preferred stock you wish to purchase per right, which may be either \$1.60, \$1.00 or \$0.50. For each right you exercise, you agree to purchase the number of shares of preferred stock equal to the amount that you subscribe for per right divided by the purchase price per share of preferred stock. Due to the tax restrictions described below, the maximum number of shares that you may purchase may be less than the amount you subscribe for, in which case the subscription agent will return the unused portion of your subscription payment, plus interest accruing after the closing date, promptly following the closing of the rights offering.

The purchase price per share of preferred stock will be the lesser of \$0.51 and 90% of the average of the last sale price of our common stock over the twenty trading days through and including the fourth trading day prior to the closing of the rights offering, as adjusted to reflect the proposed one-for-ten reverse split of our common stock. Assuming the reverse split is effected as proposed, the purchase price per share of preferred stock will be the lesser of \$5.10 and 90% of the average price of the common stock on a pre-split basis multiplied by ten. We will make a public announcement of the purchase price promptly following the close of trading on the fourth trading day prior to the closing date of the rights offering.

The rights are not transferrable, which means that only you may exercise them. You may not sell, give away or otherwise transfer your rights to anyone else.

If I wish to exercise my rights, do I have to exercise all of my rights?

No. You may exercise some or all of your rights. However, the dollar amount of preferred stock you subscribe for per right must be the same for all of the rights you exercise.

If I wish to exercise my rights, how much preferred stock should I subscribe for per right?

If you wish to be certain to maintain your approximate ownership percentage, you should exercise all of your rights for \$1.60 per right, which will allow you to maintain your approximate ownership percentage even if all of the other rights are exercised. If you acquired additional shares of our common stock after the record date for the rights offering, you will not receive rights for those shares and, as a result, you will not be able to maintain your approximate ownership percentage with respect to those shares. If you

Table of Contents

exercise your rights for \$1.00 or \$0.50 per right, your ownership percentage may decrease depending on how many other stockholders exercise their rights.

If you wish to invest less than the maximum of \$1.60 for each right you own, you generally will be able to purchase more preferred stock if you exercise all of your rights for a lower subscription amount than if you exercise fewer of your rights at a higher subscription amount. For example, you generally will be able to purchase more preferred stock if you exercise all of your rights for \$0.50 than if you exercise half of your rights for \$1.00.

Do I have to own common stock after the record date to participate in the rights offering?

Yes. Due to the tax restrictions described below, you may not increase your ownership percentage in eLoyalty through the rights offering. Therefore, on the closing date of the rights offering you must own at least one pre-split share of our common stock for each right you have exercised. If the one-for-ten reverse split of our common stock is effected prior to the closing date as proposed, you must own one tenth of a share of our common stock on the closing date for each right you have exercised. In the rights certificate, you will be asked to confirm that you will meet this requirement on the closing date. If you fail to meet this requirement, we have the right to rescind your purchase of the preferred shares in the rights offering.

What if I sell shares of common stock after the record date?

You are receiving one right for each share of common stock you held on the record date. If you sell shares of common stock after the record date, the number of rights that you may exercise will be reduced unless you acquire additional shares prior to the closing of the rights offering. On the closing date, you must hold at least one pre-split share of common stock for each right you have exercised.

Why is eLoyalty offering the rights?

We are offering the rights to raise capital and to allow our stockholders to maintain their approximate percentage ownership interest in eLoyalty. We have entered into an agreement with several funds managed by Technology Crossover Ventures and Sutter Hill Ventures to issue up to \$25.0 million in Series B convertible preferred stock in a private placement. Our board of directors has determined that it is appropriate to allow our other stockholders to maintain their approximate percentage ownership in eLoyalty if they so desire by offering them the right to purchase shares of Series B convertible preferred stock at the same price as in the private placement.

What is the preferred stock?

The Series B convertible preferred stock is a new series of preferred stock that our board of directors has authorized in connection with the private placement and the rights offering. Each share of preferred stock will accrue dividends at a rate of 7% per annum, will be entitled to a preference upon liquidation and will be convertible into one share of our common stock beginning six months after the closing date of the rights offering, subject to adjustment for stock splits, stock dividends and similar actions. The preferred stock may not be transferred until one year after the closing date, subject to limited exceptions.

Are there limits on the amount eLoyalty can raise in the private placement or the rights offering?

Yes. For our 100% spin-off from Technology Solutions Company (TSC) in February 2000 to remain tax free to TSC, no person or persons may acquire, directly or indirectly, 50% or more of our stock, measured by voting power or value, as part of a plan that includes the spin-off. Under applicable tax laws, there is a rebuttable presumption that any acquisitions of our voting stock within two years before or after the spin-off are part of such a plan. Although we do not believe that the issuance of the preferred stock in connection with the private placement and the rights offering should be treated as part of such a plan, we have structured the private placement and the rights offering in a way that we believe will enable our spin-off to remain tax-free to TSC even if the issuances were treated as part of such a plan.

Table of Contents

As a result of these tax restrictions, we have structured the private placement so that the maximum amount of preferred stock that we can issue in the private placement, without issuing any additional shares in the rights offering, is approximately 22.2 million shares, which would result in a maximum of \$11.3 million in proceeds. However, if we issue shares in the rights offering, we will be able to issue additional shares in the private placement because the shares issued in the rights offering would reduce the ownership percentage of the investors in the private placement. We would be able to issue the maximum of \$25.0 million of preferred stock in the private placement if we issue \$16.5 million to \$33.8 million or more of preferred stock in the rights offering, depending on the number of rights that are exercised and the dollar amount of preferred stock subscribed for per right.

Because of these tax restrictions, we have structured the rights offering to limit the number of shares that you may purchase upon exercise of your rights.

How many shares of preferred stock may I purchase?

The maximum number of shares that you may purchase in the rights offering is limited to the number of shares that will allow you to maintain, but not increase, your approximate ownership percentage in eLoyalty immediately prior to the private placement and the rights offering, but excluding shares of our common stock acquired after the record date for the rights offering. As a result, the maximum number of shares that you may purchase will depend on the number of shares issued in the private placement and the number of shares issued to other stockholders who exercise their rights.

To exercise your rights, you must specify the maximum dollar amount of preferred stock you wish to subscribe for per right. You may subscribe for:

\$1.60 of preferred stock per right, in which case you must send the subscription agent a payment equal to \$1.60 multiplied by the total number of rights you wish to exercise;

\$1.00 of preferred stock per right, in which case you must send the subscription agent a payment equal to \$1.00 multiplied by the total number of rights you wish to exercise; or

\$0.50 of preferred stock per right, in which case you must send the subscription agent payment equal to \$0.50 multiplied by the total number of rights you wish to exercise.

If you subscribe for \$1.60 of preferred stock per right, your ownership percentage of eLoyalty following the private placement and the rights offering will be approximately the same as your ownership percentage immediately prior to the private placement and the rights offering, even if all of the other rights are exercised. If you subscribe for \$1.00 or \$0.50 per right, your ownership percentage may decrease depending on the total proceeds we receive from the rights offering and the private placement. For example, if you subscribe for \$1.00 of preferred stock per right, your ownership percentage will decrease if the total proceeds from the rights offering and the private placement are more than \$57.4 million. If you subscribe for \$0.50 per right, your ownership percentage will decrease if the total proceeds are more than \$28.6 million.

You may not increase your ownership percentage through the exercise of rights. As a result, the maximum amount of preferred stock that you may purchase may be less than the amount you subscribe for, in which case the subscription agent will return the unused portion of your subscription payment promptly following the closing of the rights offering, plus interest accruing after the closing date of the rights offering. For example, if you subscribe for \$1.60 per right and the total proceeds from the rights offering and the private placement are \$57.4 million, the unused portion of your subscription payment that would be returned to you would be \$0.60 per right, plus any accrued interest.

The number of shares you will receive will be equal to the amount of your subscription payment that is accepted divided by the purchase price per share of preferred stock. We will not issue fractional shares. If the exercise of your rights would result in your receipt of fractional shares, the number of shares issued to you will be rounded down to the nearest whole share.

Table of Contents

How did eLoyalty determine the purchase price?

The purchase price per share of preferred stock was the result of arms length negotiations between us and the investors in the private placement. The maximum price per share of \$0.51 is equal to 90% of the average of the last sale price of our common stock over the twenty trading days prior to September 5, 2001, the date on which we reached agreement in principle on the material terms of the private placement. Our directors who are affiliated with Technology Crossover Ventures, Jay C. Hoag, and Sutter Hill Ventures, Tench Coxe, did not participate in certain key parts of the board of directors deliberations regarding the private placement. They also abstained from voting when the board of directors voted to approve the purchase price and the other terms of the private placement and the amendment to our certificate of incorporation to increase our authorized capital stock, which were unanimously approved by the other directors.

How do I exercise my rights?

You must properly complete the enclosed rights certificate and deliver it, along with an amount equal to either \$1.60, \$1.00 or \$0.50 multiplied by each right you wish to exercise, to the subscription agent before 5:00 p.m., New York City time, on December 19, 2001.

The subscription agent will hold the subscription payments in an escrow account that is separate from eLoyalty's accounts. After the closing, the subscription agent will mail to you a certificate for the shares of preferred stock you purchased. If you subscribe for more shares than you are eligible to purchase, the subscription agent will also return the unused subscription amount promptly following the closing of the rights offering, plus interest accruing after the closing date of the rights offering.

Must I pay the subscription price in cash?

All stockholders granted rights who wish to participate in the rights offering must timely pay the subscription price by wire transfer, certified or cashier's check drawn on a U.S. bank, U.S. postal money order or personal check that clears before the expiration time of the rights offering.

What if a broker, bank, trust company or other nominee is the record holder of my shares?

If you wish to exercise your rights, please promptly contact the broker, bank, trust company or other nominee holding your shares. Your broker or other nominee holder is the record holder of the shares you own and must exercise the rights on your behalf for shares you wish to purchase. The broker, bank or other nominee has been requested to contact you for instructions on exercising your rights.

How soon must I act?

The rights expire at 5:00 p.m., New York City time, on December 19, 2001. The subscription agent must actually receive all required documents and payments before that time and date. Rights not exercised by the expiration date will be null and void.

We will make a public announcement of the purchase price per share of the preferred stock to be issued in the rights offering promptly following the close of trading on the fourth trading day prior to the closing date of the rights offering. If you intend to wait to exercise your rights until the purchase price is announced, you must carefully review the procedures described in this prospectus to ensure that your subscription payment and all required documents are received by the subscription agent before the expiration time.

After I exercise my rights, can I change my mind?

No. Once you send in your rights certificate and payment, you cannot revoke the exercise of your rights, even if you later learn information about us that you consider to be unfavorable. You should not exercise your rights unless you are certain that you wish to purchase preferred stock.

Table of Contents

Is the rights offering subject to any conditions?

Yes. The closing of the rights offering is conditioned on the closing of the private placement. We have called a special meeting of stockholders to be held on December 18, 2001 at which we will ask stockholders to approve, among other matters, the issuance of the shares in the private placement, and amendments to our certificate of incorporation to increase the number of shares of common stock and preferred stock that we are authorized to issue and to effect a one-for-ten reverse split of our common stock. We will not complete the rights offering or the private placement unless stockholders approve each of those proposals and the amendments to our certificate of incorporation are effective.

The private placement is subject to a number of other conditions to closing, including that all of the representations and warranties we made in the share purchase agreement for the private placement are true in all material respects, that our business has not suffered a material adverse change and that we have received an opinion of counsel to the effect that the private placement and rights offering will not cause the distribution of our stock by TSC in February 2000 to be taxable under Section 355(e) of the Internal Revenue Code of 1986, as amended.

Can I purchase additional shares of preferred stock beyond those that I have the right to purchase?

No. You can only exercise the rights that you are granted in the rights offering. If other stockholders do not exercise their rights, neither you nor anyone else will have the right to exercise them.

Can I transfer my rights?

No. Your rights are not transferrable. Only you may exercise them.

Can I transfer the shares of preferred stock?

The preferred stock may not be transferred until one year from the date it is issued to you, except for transfers:

in connection with a consolidation or merger of eLoyalty with or into any other corporation or other entity or person, or any other corporate reorganization, in which our stockholders immediately prior to such transaction own less than 50% of our voting power immediately after such transaction, or any transaction or series of related transactions to which we are a direct contracting party in which in excess of 50% of our voting power is transferred or in connection with a sale, lease or other disposition of all or substantially all of our assets;

in connection with a distribution by a partnership or limited liability company to its affiliates or current or former partners or members; or

by will or by the laws of intestate succession.

Is the preferred stock convertible into our common stock?

Yes. The Series B convertible preferred stock will be convertible into shares of common stock at your option beginning six months after the closing of the rights offering, at a rate of one share of common stock for each share of preferred stock. The number of shares of common stock that we will issue upon conversion of the preferred stock will be adjusted if we split our stock or pay dividends in shares of stock or take similar actions, unless we take similar actions with respect to the preferred stock.

The preferred stock will also convert automatically into shares of common stock at the same conversion rate if at any time beginning six months after the closing the last sale price of our common stock is at least five times the original purchase price per share of the preferred stock for 30 consecutive trading days and, in connection with the shares of preferred stock issued in the private placement, the registration statement we have agreed to file with respect to those shares is effective.

Table of Contents

How will the proposed reverse split of the common stock affect the preferred stock?

We intend to effect a one-for-ten reverse split of our common stock shortly before the closing of the rights offering, subject to the approval of the holders of our common stock at the special meeting of stockholders to be held on December 18, 2001. We are effecting the reverse stock split (1) to reduce the number of our shares that will be outstanding after giving effect to the private placement and the rights offering to allow us to rationalize our resulting equity capital structure, (2) to enhance the acceptability and marketability of our common stock to the financial community and the investing public, and (3) to attempt to increase the per share market price of our common stock above the \$1.00 minimum bid level required to maintain our Nasdaq National Market listing.

If the reverse split is effected:

each right will continue to be exercisable for \$1.60, \$1.00 or \$0.50 of preferred stock per right;

the purchase price and the liquidation preference per share of preferred stock will be the lesser of (1) \$5.10 per share, and (2) 90% of the average of the last sale price of our common stock on a pre-split basis over the twenty trading days through and including the fourth trading day prior to the closing date of this rights offering multiplied by ten; and

each share of preferred stock initially will be convertible into one share of post-split common stock, subject to adjustment for future stock splits, stock dividends and similar actions.

Is exercising my rights risky?

The exercise of your rights involves risks. Exercising your rights means buying shares of our preferred stock, and should be considered as carefully as you would consider other equity investments. Among other things, you should carefully consider the risks described under the heading **Risk Factors** beginning on page 20.

Has eLoyalty's board of directors made a recommendation regarding the rights offering?

Our board of directors has determined that it is appropriate to allow our other stockholders to maintain their approximate percentage ownership in eLoyalty if they so desire by offering them the right to purchase shares of Series B convertible preferred stock at the same price as in the private placement. However, the decision whether to exercise your rights must be made by you based on your evaluation of our business and the terms of the offering. Our board of directors does not make any recommendation to you about whether you should exercise your rights.

What fees or charges apply if I exercise my rights?

We are not charging any fees or sales commissions to issue rights to you or to issue shares to you if you exercise your rights. If you exercise your rights through a broker or other holder of your shares, you are responsible for paying any fees that person may charge.

When will I receive my new shares of preferred stock?

If you purchase shares of preferred stock through the rights offering, you will receive certificates representing those shares as soon as practicable after December 19, 2001. Because the shares of preferred stock will be subject to restrictions on transfer for one year from the date they are issued, the shares will be issued in certificated form and will bear a legend referring to the restrictions on transfer. We do not intend to issue shares in book-entry form through a depository. Subject to state securities laws and regulations, we have the discretion to delay distribution of any shares of preferred stock you may have elected to purchase by exercise of your rights in order to comply with state securities laws.

Table of Contents

What are the U.S. federal income tax consequences of exercising my rights?

The receipt and exercise of your rights will not be taxable under U.S. federal income tax laws. You should, however, seek specific tax advice from your personal tax advisor in light of your personal tax situation and as to the applicability and effect of any other tax laws. See Material U.S. Federal Income Tax Consequences.

What happens if I choose not to exercise my rights?

You are not required to exercise your rights or otherwise take any action in response to this rights offering. If you do not exercise your rights and the rights offering is completed, the number of shares of our common stock you own will not change (except as a result of the proposed one-for-ten reverse stock split) but your percentage ownership of our total outstanding voting stock will decrease. Your net book value per share will also decrease. Your percentage ownership may also decrease and you may suffer a decrease in your net book value per share if you exercise your rights for less than \$1.60 per right, or if you exercise less than all of your rights.

How many shares of common stock and preferred stock of eLoyalty will be outstanding after the private placement and the rights offering?

The number of shares of preferred stock of eLoyalty outstanding after the private placement and the rights offering depends on the number of shares purchased in the private placement and the number of shares issued in the rights offering. If all of the stockholders who are eligible to exercise their rights exercise their rights for the maximum amount, there will be approximately 170,570,700 shares of preferred stock outstanding (or approximately 17,057,070 as adjusted for the one-for-ten reverse split of the common stock), assuming a purchase price of \$0.51 per share. There will be approximately 57,351,231 shares of common stock outstanding (or approximately 5,735,123 shares as adjusted for the one-for-ten reverse split of the common stock), after giving effect to the issuance of approximately 5,700,000 shares in connection with an offer we made to our officers and employees to exchange some of their outstanding options for common stock, and assuming we do not issue any other shares of our common stock after the date of this prospectus. Each share of preferred stock will be convertible into one share of common stock beginning six months after the closing of the rights offering, subject to adjustment for stock splits, stock dividends and similar actions.

What effect will the private placement and the rights offering have on the ownership percentage of Technology Crossover Ventures and Sutter Hill Ventures?

We expect the percentage ownership of Technology Crossover Ventures and Sutter Hill Ventures in our company to increase as a result of the private placement. If Technology Crossover Ventures and Sutter Hill Ventures purchase the maximum number of shares they could purchase in the private placement without any exercise of rights, the ownership percentage of Technology Crossover Ventures would increase from approximately 13.0% to approximately 26.1%, and the ownership percentage of Sutter Hill Ventures would increase from approximately 3.7% to approximately 13.8%, in each case after giving effect to the issuance of approximately 5.7 million shares in connection with the offer we made to our officers and employees to exchange options for common stock. As a result of the tax restrictions described above, we have structured the private placement and the rights offering to limit the aggregate ownership percentage of Technology Crossover Ventures and Sutter Hill Ventures and their affiliates to a maximum of 47.0% of the voting power or value of our outstanding stock.

How much money will eLoyalty receive from the private placement and the rights offering?

The amount of money we will raise from the private placement and the rights offering depends on the number of rights exercised for \$1.60, \$1.00 and \$0.50. If every stockholder that is eligible to exercise rights exercises their rights for \$1.60 per right, the maximum proceeds from the private placement and the rights offering will be approximately \$87.0 million. It is unlikely that all eligible stockholders will exercise their

Table of Contents

rights. The table on page 45 shows the proceeds that we would receive assuming various levels of participation in the rights offering.

Can eLoyalty cancel the rights offering?

Yes. Our board of directors will cancel the rights offering if stockholders do not approve the private placement, if the private placement does not otherwise close by February 1, 2002 or if we and the investors in the private placement agree to terminate the share purchase agreement. If we cancel the rights offering, we will promptly refund any money received from stockholders, without interest.

What if I have more questions?

If you have more questions about the rights offering or need additional copies of the rights offering documents, please contact the information agent, MacKenzie Partners, Inc., at (800) 322-2885.

Table of Contents

PROSPECTUS SUMMARY

This summary highlights the information contained elsewhere in or incorporated by reference into this prospectus. Because this is only a summary, it does not contain all of the information that you should consider before deciding whether to exercise your rights. For a more complete understanding of this rights offering, the preferred stock, the common stock and our company, we encourage you to read this entire prospectus, including the information under the heading Risk Factors, and the documents to which we refer you under the heading Documents Incorporated by Reference.

eLoyalty

We are a leading management consulting and systems integration company focused exclusively on customer relationship management (CRM). We deliver a broad range of services throughout North America, Europe and Australia including strategy and measurement, program management, customer service operations, technology enablement, change management and on-going technical managed services. The combination of methodologies and technical expertise enables eLoyalty to deliver the tangible economic benefits of customer loyalty for our Fortune 1000 clients. Since our inception in 1994 as a business unit of Technology Solutions Company (TSC), we have developed management consulting and technology capabilities in an effort to lead the development of, and stay at the forefront of, the CRM market, with the specific focus on incorporating new technologies into CRM solutions.

We were incorporated in Delaware in May 1999 as a wholly-owned subsidiary of TSC in anticipation of a spin-off from TSC. In February 2000, TSC transferred the businesses of its eLoyalty division to the recently-formed Delaware corporation and declared a dividend, payable to TSC stockholders, based upon a ratio of one share of our common stock for every one share of TSC common stock held. Effective February 15, 2000, the shares of our common stock were distributed to TSC s stockholders and eLoyalty became a separate, publicly traded company.

Our executive offices are located at 150 Field Drive, Suite 250, Lake Forest, Illinois 60045, and our telephone number at that address is (847) 582-7000.

Recent Developments

Although the current business environment remains challenging, we have experienced some stabilization in our North American sales expectations. We have won several engagements with new clients and sold additional project work to certain existing clients within the pharmaceutical, healthcare and automotive industries.

As of the date of this prospectus, we have not experienced any material financial impact on current client commitments as a result of the terrorist attacks in the United States on September 11, 2001. However, it is too early to assess the impact, if any, of these events and any responsive actions on our future business outlook.

We have completed a substantial reorganization of our North American business. Under the new organization, all field personnel will be in one of two areas:

Demand groups focusing on revenue generation and the management of client relationships; and

Delivery groups fulfilling client engagements and expanding our methodologies and capabilities.

We expect that the reorganization will increase our focus on clients by enabling demand executives to concentrate on client relationship activities, improve our operational effectiveness and efficiency by aligning billable consultants around core skills and enhance the quality of the work we deliver to our clients.

In addition, we have made several improvements to our business operating processes. These process improvements have led to improved cash collections, reduced non-billable expenses and improved focus on utilization management during the third quarter 2001.

Table of Contents

We took cost reduction actions in July and September 2001 which resulted in a third quarter special charge of \$7.1 million. We have announced additional cost reduction actions planned for the fourth quarter 2001, including headcount reductions. We currently estimate that these planned cost reduction actions will result in an estimated \$3.0 million to \$4.0 million special charge in the fourth quarter 2001. We expect that these fourth quarter actions and the actions taken in September 2001 will result in quarterly pre-tax savings of approximately \$8 million to be fully realized in the first quarter of 2002.

Private Placement

We have entered into a share purchase agreement with two of our existing stockholders, Technology Crossover Ventures and Sutter Hill Ventures, to issue up to \$25.0 million in Series B convertible preferred stock in a private placement that will close concurrently with the rights offering. Technology Crossover Ventures, which currently owns 7,430,440 shares, or approximately 13.0%, of our common stock, has agreed to purchase up to \$15 million of preferred stock, and Sutter Hill Ventures, which together with certain related entities currently owns 2,123,004 shares, or approximately 3.7%, of our common stock has agreed to purchase up to \$10 million of preferred stock. The foregoing percentages give effect to the issuance of approximately 5,700,000 shares in connection with an offer we made to our officers and employees to exchange options for common stock.

The closing of the private placement is conditioned upon stockholder approval of the private placement and other conditions, including that all of the representations and warranties we made in the share purchase agreement are true in all material respects, that our business has not suffered a material adverse change and that we have received an opinion of counsel to the effect that the private placement and rights offering will not cause the distribution of our stock by TSC in February 2000 to be taxable under Section 355(e) of the Internal Revenue Code of 1986, as amended. The closing of the private placement is also conditioned upon the closing of the rights offering and approval by our stockholders and consummation by us of certain changes to our authorized capital and a one-for-ten reverse stock split.

As a result of tax law requirements relating to our tax free spin-off from TSC, the maximum amount of preferred stock that we can issue in the private placement, without issuing any additional shares in the rights offering, is approximately 22.2 million shares, which would result in a maximum of \$11.3 million in proceeds. However, if we issue shares in the rights offering, we will be able to issue additional shares in the private placement because the shares issued in the rights offering would reduce the ownership percentage of the investors in the private placement. We would be able to issue the maximum of \$25.0 million of preferred stock in the private placement if we issue \$16.5 million to \$33.8 million or more of preferred stock in the rights offering, depending on the number of rights that are exercised and the dollar amount of preferred stock subscribed for per right.

One of our directors, Jay C. Hoag, is a managing member of the general partner of entities affiliated with Technology Crossover Ventures, and another director, Tench Coxe, is a managing director of the general partner of Sutter Hill Ventures. Because of their interest in the private placement, Messrs. Hoag and Coxe did not participate in certain key parts of the board of directors' deliberations regarding the private placement. They also abstained from voting when the board of directors voted to approve the purchase price and the other terms of the private placement and the amendment to our certificate of incorporation to increase our authorized capital stock, which were unanimously approved by the other directors.

We have also agreed to use our reasonable best efforts to register the shares of common stock issuable upon conversion of the preferred stock issued in the private placement within 180 days after the closing date.

Table of Contents

Special Meeting of Stockholders

We have called a special meeting of stockholders to be held on December 18, 2001 at which we will ask stockholders to approve:

the issuance of the preferred stock in the private placement;

an amendment to our certificate of incorporation to increase the number of shares of common stock and preferred stock that we are authorized to issue; and

an amendment to our certificate of incorporation to effect a one-for-ten reverse split of our common stock and reduce our authorized common stock to reflect the reverse split.

Approval of the private placement will require the affirmative vote of both (1) a majority of our outstanding shares of common stock present or represented by proxy at the special meeting and entitled to vote, and (2) a majority of our outstanding shares of common stock present or represented by proxy at the special meeting and entitled to vote, excluding votes cast by the investors in the private placement and their affiliates. Approval of the amendment to our certificate of incorporation and the reverse stock split each require the affirmative vote of a majority of our outstanding shares of common stock entitled to vote at the special meeting. We will not complete the rights offering unless stockholders approve the issuance of preferred stock in the private placement and the amendments to our certificate of incorporation to increase our authorized capital and effect the reverse stock split.

Other Information

We are issuing one right for each outstanding share of our common stock as of the record date for the rights offering. However, under the terms of the share purchase agreement governing the private placement, the investors in the private placement cannot exercise their rights. In addition, rights issued in respect of restricted stock held by our officers and employees that has not vested prior to the closing date cannot be exercised. As a result, the information in this prospectus regarding the amount and percentage of rights exercised is based on the amount and percentage of rights that are eligible to be exercised and excludes rights that cannot be exercised.

Unless otherwise indicated, the information in this prospectus:

assumes a purchase price of \$0.51 per share of preferred stock in the rights offering and the private placement (the second table on page 46 illustrates the impact of a lower purchase price on the proceeds to us from the rights offering and private placement);

assumes a value of our common stock of at least 83.3% of the value of the preferred stock (or a value of \$0.43 per share of common stock assuming a preferred stock purchase price of \$0.51), which would result in the value of the preferred stock for purposes of the tax restrictions being no more than 120% of the value of the common stock; and

gives effect to the issuance of approximately 5.7 million shares of common stock in connection with an offer we made to our officers and employees to exchange some of their outstanding options for shares of restricted stock that vest over a five-year period or, in the case of non-U.S. employees, shares of common stock to be issued over a five-year period.

In addition, the information in this prospectus has been presented without giving effect to the proposed one-for-ten reverse split of our common stock. If stockholders approve the reverse split, we intend to effect it prior to the closing of the private placement and the rights offering. If the reverse split is effected:

each right will continue to be exercisable for \$1.60, \$1.00 or \$0.50 of preferred stock per right;

the purchase price and the liquidation preference per share of preferred stock will be the lesser of (1) \$5.10 per share, and (2) 90% of the average of the last sale price of our common stock on a pre-split basis over the twenty trading days through and including the fourth trading day prior to the closing date of this rights offering, multiplied by ten; and

Table of Contents

each share of preferred stock initially will be convertible into one share of post-split common stock, subject to adjustment for future stock splits, stock dividends and similar actions.

The Rights Offering

Rights granted	<p>We have granted to each person who was a record holder of our common stock on the record date one right to purchase shares of Series B convertible preferred stock for each share of common stock then held.</p> <p>To exercise your rights, you must deliver a rights certificate along with payment of the applicable subscription price.</p>
Securities offered	<p>We are offering shares of 7% Series B convertible preferred stock, which is a new class of preferred stock.</p>
Exercise some or all of your rights	<p>You may exercise some or all of your rights, or you may choose not to exercise any of your rights.</p>
Number of shares that may be purchased and subscription price	<p>The maximum number of shares that you may purchase in the rights offering is limited to the number of shares that will allow you to maintain, but not increase, your approximate ownership percentage in eLoyalty immediately prior to the private placement and the rights offering, excluding shares of our common stock acquired after the record date for the rights offering. As a result, the maximum number of shares that you may purchase will depend on the number of shares issued in the private placement and the number of shares issued to other stockholders who exercise their rights.</p> <p>To exercise your rights, you must specify the maximum dollar amount of preferred stock you wish to subscribe for per right. You may subscribe for:</p> <p style="padding-left: 40px;">\$1.60 of preferred stock per right, in which case you must send the subscription agent a payment equal to \$1.60 multiplied by the number of rights you have exercised;</p> <p style="padding-left: 40px;">\$1.00 of preferred stock per right, in which case you must send the subscription agent a payment equal to \$1.00 multiplied by the number of rights you have exercised; or</p> <p style="padding-left: 40px;">\$0.50 of preferred stock per right, in which case you must send the subscription agent a payment equal to \$0.50 multiplied by the number of rights you have exercised.</p> <p>If the maximum amount of preferred stock that you may purchase is less than the amount you subscribe for, the subscription agent will return the unused portion of your subscription payment promptly following the closing of the rights offering, plus interest accruing after the closing date of the rights offering.</p> <p>We will not issue fractional shares. If the exercise of your rights would result in your receipt of fractional shares, the number of shares issued to you will be rounded down to the nearest whole share.</p>

Table of Contents

Purchase price of preferred stock	<p>The purchase price per share of preferred stock is the lesser of \$0.51 and 90% of the average of the last sale price of our common stock on a pre-split basis over the twenty trading days through and including the fourth trading day prior to the closing of the rights offering, as adjusted to reflect the proposed one-for-ten reverse split of the common stock. If the reverse split is effected as proposed, the purchase price per share of preferred stock will be the lesser of \$5.10 and 90% of the average price of the common stock described above on a pre-split basis multiplied by ten.</p> <p>We will make a public announcement of the purchase price promptly following the close of trading on the fourth trading day prior to the closing date of the rights offering.</p>
Basis for purchase price	<p>The purchase price per share of preferred stock was the result of arms length negotiations between us and the investors in the private placement.</p>
Record date	<p>October 8, 2001</p>
Requirement to hold shares on closing date	<p>On the closing date of the rights offering, you must hold at least one pre-split share of our common stock for each right you have exercised. In the rights certificate, you will be asked to confirm that you will meet this requirement on the closing date.</p>
Expiration date and time	<p>The rights expire at 5:00 p.m., New York City time, on December 19, 2001, unless we extend it.</p>
Reasons for the rights offering	<p>We are offering the rights to raise capital and allow our stockholders to maintain their approximate percentage ownership interest in eLoyalty, after giving effect to the private placement and the rights offering.</p>
Use of proceeds	<p>We intend to use the proceeds of the private placement and the rights offering for general corporate purposes.</p>
Conditions to the rights offering	<p>The rights offering is conditioned upon the closing of the private placement. The private placement is conditioned on stockholder approval and other conditions.</p>
No Board recommendation	<p>Our board of directors makes no recommendation to stockholders regarding the exercise of rights under this offering. Stockholders who exercise any rights risk investment loss on new money invested. We refer you to the section entitled Risk Factors.</p>
Transferability of rights	<p>The rights are not transferable.</p>
No revocation	<p>If you exercise any rights, you are not allowed to revoke or change your exercise or request a refund of monies paid.</p>
Subscription agent	<p>Mellon Bank, N.A.</p>
Information agent	<p>MacKenzie Partners, Inc.</p>
Procedure for exercising rights	<p>To exercise rights, you must complete the enclosed rights certificate and deliver it, along with a payment of the applicable</p>

Table of Contents

subscription price, to the subscription agent prior to the expiration date.

You may deliver the documents and payments by mail, hand delivery or commercial courier. If regular mail is used for this purpose, we recommend using insured, registered mail. You may also deliver documents by facsimile and payments by wire transfer.

Nominee accounts

If you wish to exercise your rights and purchase shares in this rights offering and your shares of common stock are held by a broker, bank, trust company or other nominee, you should promptly contact those record holders and request them to exercise the rights on your behalf.

You are responsible for the payment of any fees that brokers or other persons holding your shares may charge in connection with the exercise of your rights and the purchase of your shares.

Shares of common stock outstanding

51,651,231 shares outstanding on November 7, 2001 (or approximately 5,165,123 shares after giving effect to the proposed reverse stock split), before giving effect to the issuance of approximately 5,700,000 shares of common stock in exchange for outstanding employee stock options.

Shares of preferred stock to be outstanding after the private placement and the rights offering

170,570,700 shares of preferred stock outstanding, assuming the exercise of all of the rights for \$1.60 per right and a purchase price of \$0.51 per share (or approximately 17,057,070 shares after giving effect to the proposed reverse split of our common stock).

U.S. federal income tax consequences

For U.S. federal income tax purposes, a stockholder will not recognize taxable income upon the receipt or exercise of rights. See Material U.S. Federal Income Tax Consequences.

We urge you to consult your own tax adviser concerning the tax consequences of this rights offering under your own tax situation.

This prospectus does not summarize tax consequences arising under state, local or foreign tax laws, or any tax laws relating to special tax circumstances or particular types of taxpayers.

Stock certificates

We will deliver stock certificates representing shares of preferred stock purchased upon exercise of your rights as soon as practicable after the closing of the rights offering. The certificates will contain a legend referring to the restrictions on transfer of the preferred stock.

Transfer, paying and conversion agent

Mellon Investor Services LLC (an affiliate of Mellon Bank, N.A.) will act as transfer, paying and conversion agent for the preferred stock.

Table of Contents

Withdrawal, amendment and extension	We may withdraw, amend or extend the rights offering at any time prior to the expiration date. If we withdraw the rights offering, we will return all funds received in the rights offering without interest to those persons who exercised their rights and subscribed for shares in the rights offering.
Reverse stock split	<p>We intend to effect a one-for-ten reverse split of our common stock shortly before the closing of the rights offering, subject to the approval of the holders of our common stock.</p> <p>If we effect the reverse stock split as currently proposed, each right will continue to be exercisable for \$1.60, \$1.00 or \$0.50 of preferred stock per right, but the purchase price and liquidation preference per preferred share will be the lesser of (1) \$5.10 per share, and (2) 90% of the average of the last sale price of our common stock on a pre-split basis over the twenty trading days through and including the fourth trading day prior to the closing date of this rights offering, multiplied by ten.</p>
Terms of the 7% Series B Convertible Preferred Stock:	
Restrictions on transfer of preferred stock	The shares of preferred stock that you purchase upon exercise of your rights may not be transferred until one year after the closing date of the rights offering, subject to limited exceptions.
Dividends	Dividends will accrue at a rate of 7% per year on the original purchase price of the preferred stock. We will pay the dividends, if declared by our board of directors, on January 1 and July 1 of each year, beginning July 1, 2002.
Optional conversion	The preferred stock will be convertible into shares of common stock at your option beginning six months after the closing of the rights offering.
Automatic conversion	The preferred stock will convert automatically into shares of common stock if at any time beginning six months after the closing date of the rights offering the last sale price of our common stock is at least five times the original purchase price per share of the preferred stock for 30 consecutive trading days and, in connection with the shares of preferred stock issued in the private placement, the registration statement we have agreed to file with respect to those shares is effective.
Conversion ratio	The preferred stock will be convertible into shares of common stock initially at a rate of one share of common stock for each share of preferred stock. The number of shares of common stock that we will issue upon conversion of the preferred stock will be adjusted if we split our stock or pay dividends in shares of stock or take similar actions, unless we take similar actions with respect to the preferred stock.
Liquidation preference of preferred stock	Upon our liquidation, the holders of the preferred stock would be entitled to receive an amount equal to the original purchase price

Table of Contents

of the preferred stock, plus accrued but unpaid dividends, before any payments are made to the holders of our common stock. After that amount has been paid, the holders of the preferred stock also would participate on an as-converted basis with the holders of the common stock in our remaining assets.

Upon a consolidation or merger of eLoyalty with or into any other corporation or other entity or person, or any other corporate reorganization, in which our stockholders immediately prior to such transaction own less than 50% of our voting power immediately after such transaction, or any transaction or series of related transactions to which we are a direct contracting party in which in excess of 50% of our voting power is transferred, or upon a sale, lease or other disposition of all or substantially all of our assets, the holders of the preferred stock would be entitled to the amounts described in the preceding paragraph unless the holders of the common stock, assuming the conversion of all of the preferred stock into common stock, would receive an amount equal to four times the original purchase price of the preferred stock, in which case the holders of the preferred stock would receive the amount that they would be entitled to if they had converted their preferred stock into common stock immediately prior to the transaction.

Voting rights

The holders of the preferred stock will vote together with the holders of the common stock as a single class, and each share of preferred stock will be entitled to a number of votes equal to the number of shares of common stock that it is convertible into, determined without regard to the limitation on conversion during the first six months after issuance.

In addition, the affirmative vote of the holders of a majority of the outstanding preferred stock, voting as a separate class, will be required to take any of the following actions:

the authorization, creation or issuance of any class or series of stock or other securities convertible into or exercisable for equity securities having rights, preferences or privileges that are equal or superior to the rights, preferences or privileges of the Series B convertible preferred stock;

any increase or decrease in the authorized number of shares of Series B convertible preferred stock; or

any amendment, waiver, alteration or repeal of any provision of our certificate of incorporation or our bylaws in a way that adversely affects the rights, preferences or privileges of the Series B convertible preferred stock.

Also, until six months after the closing date of the private placement and the rights offering, the affirmative vote of the holders of at least 85% of the outstanding preferred stock present in person or by proxy and entitled to vote at a meeting held for this purpose shall be required prior to a consolidation or merger of eLoyalty with or into any other corporation or other entity or person, or any other corporate reorganization, in which our

Table of Contents

stockholders immediately prior to such transaction own less than 50% of our voting power immediately after such transaction, or any transaction or series of related transactions to which we are a direct contracting party in which in excess of 50% of our voting power is transferred, or a sale, lease or other disposition of all or substantially all of our assets.

Redemption

The Series B convertible preferred stock does not have a stated redemption feature. However, upon a consolidation or merger of eLoyalty with or into any other corporation or other entity or person, or any other corporate reorganization, in which our stockholders immediately prior to such transaction own less than 50% of our voting power immediately after such transaction, or any transaction or series of related transactions to which we are a direct contracting party in which in excess of 50% of our voting power is transferred, or a sale, lease or other disposition of all or substantially all of our assets, the holders of the preferred stock would be entitled to their liquidation preference after the payment of which the preferred stock would be retired.

Net (loss) income
\$(56,375) \$910 \$(424) \$4,058 \$1,067 \$(543) \$335 \$2,213 \$2,926 \$3,050

Basic net (loss) income per common share(1)
\$(1.13) \$0.02 \$(0.01) \$0.10 \$0.03 \$(0.01) \$0.01 \$0.05 \$0.07 \$0.07

Edgar Filing: ELOYALTY CORP - Form S-3/A

Diluted net (loss) income per common share(1)(2)

\$(1.13) \$0.02 \$(0.01) \$0.09 \$0.02 \$(0.01) \$0.01 \$0.05 \$0.06 \$0.07

Basic weighted average shares outstanding (in millions)(1)

50.0 47.7 48.2 41.4 41.4 41.4 41.4 41.4 41.4 41.4

Dilutive weighted average shares outstanding (in millions)(2)

51.1 53.2 53.7 44.2 43.1 NA(3) 45.8 46.8 46.6 45.5

Ratio of earnings to fixed charges (unaudited)(4)
(5) 2.80x (5) 18.09x 11.68x (5) 7.32x 18.36x 110.61x NA(4)

Table of Contents

Summary Financial Data (Cont.)

- (1) In December 1999, eLoyalty issued 41.4 million shares to TSC. For periods prior to February 15, 2000, basic earnings per share has been computed based on the 41.4 million shares and diluted earnings per share has been computed based on the 41.4 million shares plus the estimated dilutive effect of common stock equivalents using the treasury stock method. For periods subsequent to February 15, 2000, basic earnings per share has been computed based on actual weighted shares outstanding and diluted earnings per share has been computed based on the actual weighted shares outstanding plus the dilutive effect of common stock equivalents using the treasury stock method.
- (2) In periods of a loss, common stock equivalents are not included in the calculation as they are antidilutive.
- (3) Dilutive share information is not available for this period (see note thirteen to the financial statements which are incorporated by reference from our Annual Report on Form 10-K for the year ended December 30, 2000).
- (4) The ratio of earnings to fixed charges represents the ratio of earnings before income taxes plus fixed charges to fixed charges. Fixed charges include net cash interest expense plus a reasonable approximation of the interest portion (33%) of rent expense. Fixed charges were \$0 for the year ended May 31, 1996.
- (5) Earnings were inadequate to cover fixed charges during the nine month period ended September 29, 2001, the year ended December 30, 2000, and the seven month period ended December 31, 1998, with coverage deficiencies of \$63.7 million, \$0.9 million and \$0.2 million, respectively.

Balance Sheet Data:

	As of September 29, 2001 (unaudited)	As of December 30, 2000	As of December 31, 1999 1998		As of May 31, 1998 1997 1996 (unaudited)		
			(in thousands)				
Cash	\$38,954	\$41,138	\$13,462	\$4,411	\$4,726	\$4,130	\$321
Working capital	42,946	109,934	54,927	26,231	23,840	13,506	6,249
Total assets	124,117	184,618	96,603	63,904	54,118	24,188	14,008
Stockholders equity	84,075	140,856	73,615	47,888	40,893	17,147	9,312

Table of Contents

RISK FACTORS

You should carefully consider each of the following risks and all of the other information included in this prospectus, and the information that we have incorporated by reference in this prospectus, before deciding to exercise your rights.

Risks Relating to Our Business

Our business is subject to the following risks, which include risks relating to the industry in which we operate.

Our business and the value of your securities may be adversely affected if we fail to maintain our listing on Nasdaq.

We face possible Nasdaq delisting which would result in a limited public market and reduced liquidity for our common stock, make obtaining future financing more difficult for us and could result in lower prices and larger spreads in the bid and ask prices for shares of our common stock. Because the preferred stock will be convertible into our common stock, a delisting from Nasdaq may adversely affect the value of the preferred stock. On August 2, 2001, we received a letter from The Nasdaq Stock Market notifying us that we had failed to maintain a minimum closing bid price of \$1.00 over the previous thirty day period, a requirement for continued Nasdaq listing. The letter further noted that we would be given until October 31, 2001 to restore our compliance with this requirement by maintaining a minimum bid price of \$1.00 for at least ten consecutive trading days prior to such date. We have not satisfied this requirement as of the date of this prospectus. If we are unable to meet the Nasdaq listing requirement, we will be notified that our securities will be delisted from Nasdaq. We would have the right to appeal any such decision, but we cannot assure you that we would be successful in our appeal.

On September 27, 2001, before the deadline specified in our notification letter, Nasdaq announced a moratorium on the \$1.00 minimum bid requirement for continued listing. Nasdaq suspended this requirement until January 2, 2002, including with respect to companies that were under review for bid price deficiencies prior to the suspension, such as eLoyalty. Nasdaq has indicated, however, that during the suspension it will consider whether to recommend further and more permanent action. As of the date of this prospectus, we are in compliance with the other Nasdaq National Market listing criteria, but the closing bid price of our common stock has been below \$1.00 since June 19, 2001. We cannot predict what action, if any, Nasdaq may take with respect to its minimum bid requirement or our continued listing from and after January 2, 2002.

If our common stock loses its Nasdaq National Market status, shares of our common stock would likely trade in the over-the-counter market in the so-called pink sheets or the OTC Bulletin Board. Selling our common stock would be more difficult because smaller quantities of shares would likely be bought and sold, transactions could be delayed, and security analysts and news media coverage of us may be reduced. These factors could result in lower prices and larger spreads in the bid and ask prices for shares of our common stock. Such delisting from the Nasdaq National Market or further declines in our stock price could also greatly impair our ability to raise additional necessary capital through equity or debt financing and may significantly increase the dilution to stockholders caused by our issuing equity in financing or other transactions.

In addition, if our common stock is not listed on the Nasdaq National Market, we may become subject to Rule 15c-9 under the Securities and Exchange Act of 1934 which imposes additional sales practice requirements on broker-dealers that sell low-priced securities, referred to as penny stocks, to persons other than established customers and institutional accredited investors. A penny stock is generally any equity security that has a market price or exercise price of less than \$5.00 per share, subject to certain exceptions, including listing on the Nasdaq National Market or the Nasdaq SmallCap Market. For transactions covered by these rules, broker-dealers must make a special suitability determination for the purchase of such securities and must have received the purchaser's written consent to the transaction prior

Table of Contents

to the purchase. Additionally, for any transaction involving a penny stock, unless exempt, the rules require the delivery, prior to the transaction, of a risk disclosure document mandated by the SEC relating to the penny stock market. The broker-dealer is also subject to additional sales practice requirements. Consequently, the penny stock rules may restrict the ability of broker-dealers to sell our securities and may affect the ability of holders to sell these securities in the secondary market and the price at which such holders can sell any such securities.

Our board of directors has called a special meeting of stockholders for December 18, 2001 to vote upon an amendment to our certificate of incorporation which would effect a one-for-ten reverse stock split of our issued and outstanding common stock. One reason we are seeking to effect the reverse stock split is to attempt to increase the per share market price of our common stock above the \$1.00 minimum bid level required by Nasdaq prior to the recent suspension. If the proposed amendment is approved by our stockholders, our board of directors will have the authority, without further stockholder approval, to effect the reverse split, pursuant to which each of our presently outstanding shares of common stock would be exchanged for new shares of common stock in an exchange ratio of one new share for every ten old shares. There can be no assurance that, if the reverse split is effected, we will meet the minimum bid price or other requirements of Nasdaq for continued inclusion of our common stock for quotation on the Nasdaq National Market.

Economic uncertainties or negative economic conditions, including a substantial or prolonged economic downturn, may continue to adversely affect our results of operations.

Demand for our services by our existing and prospective clients has decreased since 2000 and may continue to decrease because of prevailing economic uncertainties or adverse economic conditions. Continuation or worsening of this year's general economic slowdown, as well as other future negative business, capital market and economic events, conditions or volatility, may cause companies to reduce their budgets for outside consultants in general or for information technology related projects in particular, which in turn could adversely affect both the demand for our services and the related revenue stream and increase price competition. While assessment of their potential impact is difficult at present, the terrorist attacks in the United States on September 11, 2001 and any responsive actions may exacerbate negative economic, market or business conditions and uncertainties. We have experienced and may continue to experience uncertainties in connection with the attraction of new clients, the continuation of existing and new engagements with existing clients and the timing of related client commitments, including, without limitation, delays or deferrals by clients of new engagements or existing project extensions or cancellations.

Our consolidated revenues were \$26.5 million in the third quarter of 2001. This represents an approximate 53% decline as compared to the third quarter of 2000 and a 24% decline from the second quarter of 2001, which in turn followed a 24% sequential quarterly decline from the first quarter of 2001.

We also have experienced declines during 2001 in the utilization rate of our engageable field consultants. Utilization is defined as billed time as a percentage of total available billable time. Average utilization was 66% for the fiscal year 2000, 60% for the first quarter 2001, 54% for the second quarter 2001 and 51% for the third quarter 2001. Our gross profit margin (gross profits, or revenues minus project personnel costs, as a percentage of revenues) was 34% for the third quarter of 2001. This represented a decline from our 36% gross profit margin in the second quarter of 2001 and the 51% gross profit margin achieved for fiscal 2000. We have also experienced pricing competition during 2001.

We presently expect the current economic slowdown and resulting uncertain client expenditure commitments and extended decision time frames to persist during the remainder of 2001 and to continue into 2002. We are continuing to experience deferrals of proposed new projects and project extensions, with pipeline prospects being converted into firm engagements at a less certain rate and on a longer cycle than during prior years. The continuation or worsening of any of these uncertainties or conditions and resulting uncertain client expenditure commitments and extended decision time frames could further adversely affect our business and results of operations.

Table of Contents

In response to this economic environment and decline in demand for our services, we have undertaken cost reduction actions, including headcount and office space reductions. Even with such cost reduction actions, we may not be able to adequately control our costs in a timely manner. If we are unable to do so, we may be unable to compete profitably.

As a result of cost reduction activities, we recognized a special pre-tax charge of \$7.1 million (approximately \$5.0 million after tax) in the third quarter of fiscal 2001, approximately 80% of which relates to future 2001 and 2002 cash commitments for agreed employee severance payments and estimated contractual exit costs associated with office closures through 2004. This third quarter charge is in addition to a special pre-tax charge of \$22.2 million (approximately \$14.2 million after-tax) taken in the first and second quarters of fiscal 2001.

As a result of these combined year-to-date cost reduction actions, we have reduced our overall headcount by more than 44% from the end of fiscal 2000. During the fourth quarter of 2001, we initiated further cost reduction actions, including an additional workforce reduction. We expect that these fourth quarter actions will result in an estimated pre-tax special charge in the range of \$3.0-\$4.0 million (\$2.6-\$3.2 million after-tax) in the fourth quarter of fiscal 2001. We expect substantially all severance and related costs to be paid out by the end of the first quarter of 2002 pursuant to agreements entered into or to be entered into with the affected employees, and facility costs related to office closures to be paid pursuant to contractual lease terms through 2007.

We depend on a limited number of clients for a significant portion of our revenue, and the loss of a significant customer or a substantial decline in the number or scope of projects we do for a significant customer would have an adverse effect on our business.

We currently derive and expect to continue to derive a significant portion of our revenues from a limited number of clients. The volume of work that we perform for a specific client is likely to vary from year to year, and a major client in one year may not use our services in a subsequent year. However, to the extent that any significant client uses less of our services or terminates its relationship with us, as may occur as clients respond to adverse economic or demand conditions affecting their own businesses, our revenues could decline substantially. As a result, the loss of any major client could seriously harm our business.

As previously announced, in early June 2001, Agilent Technologies notified us of its cancellation of a project on which we and other third parties were engaged. Agilent had been our single largest customer, contributing approximately \$8 million, or 22.8%, of our total revenues for the second quarter of 2001 and approximately 19% and 15%, respectively, of our total revenues for the first quarter of 2001 and the prior fiscal year. In general, as our revenues have declined, our customer concentration has grown, increasing our potential exposure to the loss of a single major customer. During the third quarter of 2001, two clients each accounted for more than 10% of our revenues. Our top 20 customers contributed 86% of total revenues for the third quarter of 2001, as compared to 92% for the second quarter of 2001 and 72% for the third quarter last fiscal year.

We may have to take a significant charge to earnings and write down assets on our balance sheet if our operating results do not improve.

During the second quarter of 2001, we established a valuation allowance against the benefit of certain international operating unit tax losses previously recognized and ceased recording the benefit of losses incurred by these operating units. As of September 29, 2001, we had established a valuation allowance of \$13.8 million relating to these international operating unit tax losses.

We recorded a deferred tax asset of \$20.8 million as of September 29, 2001 reflecting primarily the benefit of U.S. loss carryforwards, which expire in periods through 2021. Realization of this asset is dependant on generating sufficient taxable income in the United States that can be offset against these loss carryforwards prior to their expiration. The amount of the deferred tax asset considered realizable, however, could be reduced in the near term through the recording of an additional valuation allowance if

Table of Contents

current estimates of the timing and amount of future taxable income during the carryforward period are significantly revised, or if we undergo an ownership change for purposes of Section 382 of the Internal Revenue Code as described under The private placement and the rights offering may jeopardize our ability to use some or all of our net operating loss carryforwards.

It may be difficult for us to sufficiently access the debt and/or equity markets to meet our financial needs.

We may need to raise additional funds in the future, through public or private debt or equity financings, which may not be available on terms favorable to us or at all. Any additional capital we raise through the sale of equity may dilute your ownership percentage in us. Although we sustained an operating and net loss for fiscal 2000 and the first nine months of fiscal 2001, and expect to continue to experience operating and net losses for the fourth quarter of fiscal 2001 and the 2001 fiscal year, we believe that existing cash resources, including the proceeds of our borrowings under our existing senior credit facility, the proceeds from the private placement and the rights offering, if any, and the proceeds to be available under a new 2002 senior credit facility for which we have received a commitment and which will replace our existing senior credit facility, will be sufficient to satisfy our operating cash needs for the next twelve months. Any future decreases in our operating results, cash flow, or stockholders' equity may impair our future ability to raise additional funds on acceptable terms. As a result, we may not be able to maintain adequate liquidity to support our operations, take advantage of new service or solutions offerings or business expansion opportunities or respond effectively to competitive pressures.

Despite our recent cost reduction activities, continuing operating and net losses or adverse impacts on our accounts receivable collection activities resulting from uncertain prevailing economic conditions and project deferrals or cancellations could require us to accelerate use of existing cash balances to fund operations for the next twelve months and limit our ability to fund capital and other discretionary expenditures. If our operating activities or net cash needs for the year were to differ materially from current expectations, there could be no assurance, given current market, credit and general economic uncertainties, that we would have access to additional capital resources on acceptable terms.

We depend on good relations with our major clients and any harm to these good relations may harm our ability to compete effectively.

To attract and retain clients, we depend to a large extent on our relationships with our customers and our reputation for high quality professional services and solutions. We create, implement and maintain CRM and other applications and CRM solutions that are often critical to our clients' businesses. While we believe that we generally enjoy good relations with our clients, if a client is not satisfied with our services, products or solutions, including those of subcontractors we employ, it may be damaging to our reputation and business. Any defects or errors in our CRM services or solutions or failure to meet our clients' expectations could result in:

delayed or lost revenues due to adverse client reaction;

requirements to provide additional services to a client at a discount or at no charge;

negative publicity, which could damage our reputation and adversely affect our ability to attract or retain clients; and

claims for damages against us, regardless of our responsibility for such failure.

In addition, if we fail to meet our contractual obligations with our clients, we could be subject to legal liabilities or loss of clients. Although our contracts typically include provisions to limit our exposure to legal claims for the services and solutions we provide and the applications and systems we develop or integrate, these provisions may not be sufficient to protect us in all cases.

Table of Contents

If we do not effectively manage the risks associated with increasingly complex client projects and new services offerings, our gross profit margins and our financial results may suffer.

We may fail to accurately estimate the time and resources necessary for the performance of our services. It can be difficult to judge the time and resources necessary to complete a project. A number of different risks must be accounted for, including, without limitation, the variability and predictability of the number, size, scope, cost and duration of client engagements, and shifts from time and materials-based engagements to alternative pricing or value-based models and variable employee utilization rates, project personnel costs and project requirements. Accurate estimates as to the costs and timing of completion of projects is particularly important for the limited number of our projects that are performed on a fixed-price or fixed-time basis. Our failure to accurately estimate or manage these risks could reduce the profitability of, or result in a loss on, our projects and could damage our client relationships and our reputation.

Our ability to retain our key existing professionals, and our ability to recruit additional professionals with specialized talents, are critical to the success of our business.

We believe that our success will depend substantially on our ability to motivate and retain highly skilled management, strategic, technical, product development and other key professional employees. As the information technology professional services industry remains people-intensive, we also expect to continue to compete with other companies in recruiting any additional needed professionals, especially those with specialized skills or experience.

We have reduced the number of employees through workforce reductions during 2001 and may take additional cost reduction measures, including additional workforce reductions. The impact on employee morale of these cost reduction measures may adversely affect our ability to retain our key professionals and attract additional needed talent. In addition, the decline in our stock price has resulted in most of our employees holding options to purchase our common stock with exercise prices that are significantly higher than the current market price of our common stock. The market price and liquidity of our common stock would be subject to further negative pressures if we were unable to maintain the listing of our common stock on the Nasdaq National Market system. Although we will replace some of these options with restricted stock, we cannot assure you that by doing so we will be successful in retaining key personnel.

If we cannot retain our key personnel, our ability to complete or retain existing projects or bid for new projects of similar scope and revenue may be adversely affected and our business could be seriously harmed. There also is no guarantee that the employee and customer non-solicitation and non-competition agreements we have entered into with our senior professionals would deter them from departing us for our competitors or that such agreements would be upheld and enforced by a court or other arbiter across all jurisdictions where we engage in business.

Our industry is very competitive and, if we fail to compete successfully, our market share and business will be adversely affected.

We operate in a highly competitive and rapidly changing market and compete with a variety of organizations that offer services similar to those we offer. The market includes a variety of participants that compete with us at various levels of our business, including strategic consulting firms, systems integrators, general information technology services providers, web consulting firms, application service providers, and other firms that provide both consulting and systems integration services and solutions. New market entrants also pose a threat to our business. We believe that our principal competitors are: Accenture, PricewaterhouseCoopers, Cap Gemini Ernst & Young, KPMG Consulting and Deloitte Consulting.

Many of our competitors have longer operating histories, more clients, longer relationships with their clients, greater brand or name recognition and significantly greater financial, technical, marketing and public relations resources than we do. As a result, our competitors may have enhanced abilities to compete for specific clients and market share generally, including through substantial economic incentives to clients to secure contracts or other forms of pricing competition. Existing or future competitors may develop or offer solutions that are comparable or superior to ours at a lower price. In addition, our competitors may

Table of Contents

be in a better position to respond quickly to new or emerging technologies and changes in client requirements or expectations. They may also develop and promote their products and services more effectively than we do and be better able to compete for skilled professionals by offering substantial compensation incentives.

We must keep pace with technological innovation and change, as well as evolving industry standards, in order to build our business.

Our industry historically has been characterized by changing technologies, the introduction of new products and services and evolving industry standards and client preferences. Our solutions must meet the requirements of and achieve significant acceptance among our current and prospective clients within this environment. Our future business will depend on our continuing ability to adapt to and incorporate changing technologies and emerging industry standards and to remain knowledgeable with respect to emerging CRM technology, customer loyalty research and applied CRM solutions.

In addition, our future business depends upon continued growth in the acceptance and use of CRM methodologies and technologies by our current and prospective clients and their customers and suppliers. Their acceptance and usage in turn may depend upon factors such as: the actual or perceived benefits of adoption and implementation of CRM methodologies and technologies, including the predictability of a meaningful return on investment, cost efficiencies or other measurable economic benefits; their actual or perceived ease of use and access to such new technologies and methodologies; and their willingness to adopt new business methods incorporating a customer-centric approach.

We cannot assure you that we will be successful in anticipating or responding to these developments and challenges on a timely or competitive basis or at all, or that our ideas and solutions will be successful in the marketplace. In addition, new or disruptive technologies and methodologies by our competitors may make our service or solutions offerings uncompetitive. Any of these circumstances could adversely affect our ability to obtain and successfully complete substantial new client engagements that are important to maintain and grow our business. The recent growth of and intensifying competition within the CRM market may increase these challenges.

We depend on our ability to rapidly learn, use and integrate software and other technology developed by third parties to successfully compete in the CRM market, and our ability to maintain and grow our business may be affected by our ability to maintain strong relationships with CRM software providers and other alliance partners.

To provide our CRM solutions and services, we rely on third party software, telephony and other infrastructure and related services. If we are unable to integrate these components in a fully functional manner, we may experience difficulties that could delay or prevent the successful development, introduction or marketing of new solutions. We could also incur substantial costs if we need to modify our services or infrastructure to adapt to changes in these third party products and services.

We have invested time and resources in seeking to maintain strong relationships with CRM software providers and we plan to make additional investments in the future. The benefits we anticipate from these relationships play an important role in our future growth strategies. We rely on these relationships with third party vendors and alliance partners to allow us to rapidly learn about their existing and next generation technologies, to develop appropriate methods to integrate their products and services into our solutions and to obtain joint sponsorship of solutions offerings. If we are unable to initiate and successfully maintain these relationships, we may fail to obtain the future benefits we hope to derive from them and significantly reduce our ability to successfully create and deploy new solutions offerings incorporating their technologies. In addition, we may be adversely affected by the failure of one or more of our vendors or alliance partners, which could lead to reduced marketing exposure, fewer sales leads or joint marketing opportunities and a diminished ability to gain access to or develop leading-edge solutions. As our most important alliance relationships are non-exclusive, our alliance partners are also free to establish similar or

Table of Contents

preferred relationships with our competitors. These circumstances could adversely impact the success of our growth strategies and that, in turn, could adversely affect our results of operations.

We are subject to risks related to adjustments in our operations, business model or geographic business locations.

As we adapt to current and future economic and demand conditions, we may incur significant unanticipated costs associated with reorganizations or other adjustments in our operations, business model and geographic business locations. These risks include, without limitation, the timely and cost-effective implementation of revised operating, financial and other infrastructure systems, operational and management structures and procedures. We may require different or additional improvements in infrastructure, computers, software and application integration or incur potential exit or closure costs as we refocus our business. Our failure to efficiently manage any such adjustments could cause us to lose business opportunities with both existing and potential clients and could adversely affect our results of operations.

We have a limited ability to protect our intellectual property rights, which are important to our success and competitive position.

Our ability to protect our proprietary software, methodologies and other intellectual property is important to our success and our competitive position. We generally rely on a combination of confidentiality policies, nondisclosure, license and other contractual arrangements with our clients, employees and corporate partners and trade secrets, copyright and trademark laws to protect our intellectual property. Despite our efforts to protect our intellectual property rights from unauthorized use by or disclosure to third parties, such parties may attempt to disclose, obtain or use our rights. The steps we take may not be adequate to prevent or deter infringement, misappropriation or other use of our intellectual property rights. In addition, we may not detect unauthorized use of, or take timely and effective actions to enforce and protect, our intellectual property rights. Existing laws of some countries in which we provide services or solutions afford more limited protection of intellectual property rights than in the United States.

We may be required to obtain licenses from others to refine, develop, market and deliver current and new services and solutions. There can be no assurance that we will be able to obtain any of these licenses on commercially reasonable terms or at all, or that rights granted by these licenses ultimately will be valid and enforceable.

Others could claim that our services, software or solutions infringe their intellectual property rights or violate contractual protections.

Although we believe that our services, software and solutions do not infringe the intellectual property rights of others, we cannot be sure of that. We or our clients may be subject to claims that our services, products or solutions, or the products of third parties that we offer to our clients, infringe the intellectual property rights of others. Any infringement claims may result in substantial costs, divert management attention and other resources, harm our reputation and prevent us from offering some services, software or solutions. A successful infringement claim against us could materially and adversely affect our business.

In our contracts, we generally agree to indemnify our clients for expenses and liabilities resulting from claimed infringement by our services, software or solutions, excluding third party components, of the intellectual property rights of others. In some instances, the amount of these indemnities may be greater than the revenues we receive from the client. In addition, our business includes the development of customized software modules in connection with specific client engagements, particularly in our systems integration business. We often assign to clients the copyright and, at times, other intellectual property rights in and to some aspects of the software and documentation developed for these clients in these engagements. Although our contracts with our clients generally provide that we also retain rights to

Table of Contents

intellectual property developed in the course of client engagements, some clients may seek rights to, and attempt to limit our ability to resell or reuse, this intellectual property.

Increasing government regulation could cause us to lose clients or impair our business.

We are subject not only to regulations applicable to businesses generally, but we and the solutions we offer to our clients also may be subject to United States and foreign laws and regulations directly applicable to electronic commerce, the Internet and data privacy. Legislation recently adopted in the United States and abroad, as well as legislative initiatives that may be considered in the future, may increase regulation of the Internet and impose additional restrictions relating to the privacy of personal data. We may be affected indirectly by any such legislation to the extent that it decreases acceptance or growth of the Internet or otherwise impacts our existing and prospective clients. Any such laws and regulations therefore could affect our existing business relationships or prevent us from getting new clients.

Risks associated with international operations may adversely affect our business.

Our international operations create special risks, including those relating to the economic conditions in each country, potential currency exchange and credit volatility, restrictions on the movement of cash and certain technologies across national borders, tax issues resulting from multiple tax laws, compliance with a variety of other foreign national and local laws and regulations, political instability and management of a geographically dispersed organization. Our ability to deploy our resources globally while accommodating a variety of local labor and immigration laws and regulations may become more challenging as we implement our operational reorganization into global delivery groups. If not adequately addressed, these risks may adversely affect our business.

A majority of our international revenue and costs have been denominated in foreign currencies, and we believe that an increasing portion will be so denominated in the future. Revenues from our operations outside the United States were 17% of our revenues for the fiscal year ended December 30, 2000 and 22% of our revenues for the nine months ended September 29, 2001. To date, we have not engaged in any foreign exchange hedging transactions, and we are therefore subject to foreign currency risk.

Our international sales growth may be limited if we are unable to support key foreign operations, customize our solutions for use in local markets, develop relationships with international service providers or establish relationships with distributors and third party vendors with substantial multinational presences. Even if we are able to successfully support international operations, we cannot be certain of continuing or increased international market demand for our solutions.

Our financial results are subject to significant fluctuations because of many factors, any of which could adversely affect the price of our common stock and the value of our preferred stock.

It is possible that in some periods our operating results may be below the expectations of public market analysts and investors. In this event, the price of our common stock may fall. Our revenues and operating results may vary significantly due to a number of factors, including those described in the preceding risk factors, many of which may not be within our control.

We must maintain our reputation and financial strength to remain competitive.

We believe that establishing and maintaining a good reputation and brand name is critical for attracting and expanding our targeted client base. In addition, some clients or potential clients may base decisions to engage us in part on the adequacy of our financial resources or other similar measures. If we are unable to establish, through our reputation and name recognition, that we are a reliable choice or if potential clients have concerns about the adequacy or certainty of our future financial resources, we may become less competitive or lose market share. If clients do not perceive our solutions to be effective or of high quality, our brand name and reputation could be materially and adversely affected.

Table of Contents

Our clients use our solutions for critical applications. Any errors, defects or other performance problems, including those in our proprietary software or products supplied by third party vendors, could result in financial or other damages. In addition to any liability we might have, performance problems could also adversely affect our brand name and reputation and therefore our future business.

Risks Relating to the Rights Offering and Private Placement

You may not convert the preferred stock into shares of common stock until six months after the closing date.

The preferred stock may not be converted into shares of our common stock until six months after the closing date. As a result, you must bear the risk of your investment in the preferred stock until at least six months after the closing date.

You may not sell the preferred stock until one year after the closing date.

The preferred stock may not be sold or transferred until one year after the closing date of the rights offering. As a result, if you do not convert your preferred stock to common stock, you must bear the risk of your investment until that time.

You may not be able to sell your preferred stock because no current market for the preferred stock exists and such a market may not develop.

There is no established trading market for the preferred stock. We do not currently intend to list the preferred stock on a national securities exchange or qualify the preferred stock for quotation on any automated quotation service such as The Nasdaq Stock Market. Accordingly, we cannot give any assurance as to:

whether an active market for the preferred stock will develop;

the liquidity of any such market;

your ability to sell the preferred stock; or

the prices that you may obtain for your preferred stock.

In addition, we do not expect the preferred stock to be eligible for clearance and settlement through a depository institution, which will require that the preferred shares be held in certificated form and may further limit the liquidity of any market for the preferred stock.

The ownership percentage of the investors in the private placement may increase significantly if all of the rights are not exercised.

The percentage ownership of Technology Crossover Ventures and Sutter Hill Ventures in our company will increase to the extent other stockholders do not exercise their rights, which would give each of them significant influence in determining the outcome of any corporate transaction or other matter submitted to our stockholders for approval, including the election of directors and mergers, consolidations and the sale of all or substantially all of our assets. If Technology Crossover Ventures and Sutter Hill Ventures purchase the maximum number of shares they could purchase without any exercise of rights, the ownership percentage of Technology Crossover Ventures would increase from approximately 13.0% to approximately 26.1%, and the ownership percentage of Sutter Hill Ventures would increase from approximately 3.7% to approximately 13.8%, in each case after giving effect to the issuance of approximately 5.7 million shares in connection with an offer we made to our officers and employees to exchange options for common stock. As a result of tax restrictions, we have structured the private placement and rights offering to limit the aggregate ownership percentage of Technology Crossover Ventures and Sutter Hill Ventures and their affiliates to a maximum of 47.0% of the voting power or value of our outstanding stock.

Table of Contents

You may not revoke or change your exercise of rights.

You are not allowed to revoke or change your exercise of rights after you send in your subscription forms and payment. If we elect to withdraw or terminate the rights offering, neither we nor the subscription agent will have any obligation with respect to the rights, except to return, without interest, any subscription payments.

You must hold at least one share of common stock on the closing date for each right you exercise.

To exercise your rights, you must hold at least one pre-split share of our common stock on the closing date for each right that you exercise. If you hold your shares from the record date through the closing date, you will be subject to the risk that the price of our common stock may decline. In addition, if you fail to hold at least one pre-split share of common stock for each right you exercise, we have the right to rescind your related purchase of preferred stock in the rights offering. If the one-for-ten reverse split of our common stock is effected prior to the closing date as proposed, you must own one tenth of a share of our common stock on the closing date for each right you have exercised.

If you do not exercise your rights, you will suffer significant dilution.

If you do not exercise your rights, you will suffer significant dilution of your percentage ownership of our equity securities relative to purchasers in the private placement and stockholders who exercise their rights. For example, if you own 100,000 shares of common stock before the rights offering, or approximately 0.17% of our common stock, and you do not exercise your rights while all other rights are exercised for \$1.60 per right, then your percentage ownership will be reduced to 0.04%. You will also suffer significant dilution in net book value per share.

The private placement and rights offering could cause our spin-off from TSC to be taxable to TSC, and we would be liable to TSC for the amount of taxes it is required to pay.

Even though our spin-off from TSC in February 2000 was structured to be tax-free to TSC, that spin-off could become taxable to TSC, although not to TSC's stockholders, under Section 355(e) of the Internal Revenue Code of 1986, as amended, if one or more persons acquire, directly or indirectly, 50% or more of our stock, measured by voting power or value, as part of a plan that includes the spin-off. For this purpose, any acquisitions of our voting stock within two years before or after the spin-off are presumed to be part of that plan, although this presumption is rebuttable. If an acquisition of our stock triggers the application of Section 355(e), TSC would recognize taxable gain to the extent that the fair market value of our stock at the time of the spin-off exceeded TSC's tax basis for that stock.

We have attempted to structure the private placement and rights offering to avoid the application of Section 355(e), and it is a condition to the closing of each of the private placement and the rights offering that we receive an opinion of counsel that the private placement and rights offering will not cause the distribution of our stock by TSC in February 2000 to be taxable under Section 355(e). However, because (1) Section 355(e) is a relatively new statute that is complex and under which there is little guidance, (2) the analysis and requirements under Section 355(e) are inherently factual in nature, and (3) an opinion of counsel is not binding on the IRS or the courts, there can be no assurance that the IRS will not assert that Section 355(e) should apply to the spin-off as a result of the private placement or rights offering, or that the courts will not uphold such a position if the IRS were to make such an assertion. In addition, the opinion of counsel will rely in part on certain assumptions and representations made by us and by the investors in the private placement as to various matters, some of which are based on our knowledge or the knowledge of the investors rather than on established facts. If an acquisition of our stock were to cause Section 355(e) to apply to our spin-off, we would be required to indemnify TSC under an agreement between us and TSC, and such liability, if it were to arise, would be significant and could exceed the value of all of our assets.

Table of Contents

The private placement and rights offering may jeopardize our ability to use some or all of our net operating loss carryforwards.

As of September 29, 2001, we had incurred significant losses in the United States during 2001. If we were to have a U.S. federal and state net operating loss (NOL) for our 2001 taxable year, we would be able to carry that NOL forward to reduce taxable income in future years. These NOL carryforwards would expire in 2021. Our ability to utilize our NOL carryforwards could become subject to significant limitations under Section 382 of the Internal Revenue Code if we undergo an ownership change. We would undergo an ownership change if, among other things, the stockholders who own or have owned, directly or indirectly, 5% or more of our common stock or are otherwise treated as 5% stockholders under Section 382 and the regulations promulgated thereunder increase their aggregate percentage ownership of our stock by more than 50 percentage points over the lowest percentage of the stock owned by these stockholders at any time during the testing period, which is generally the three-year period preceding the potential ownership change. In the event of an ownership change, Section 382 imposes an annual limitation on the amount of taxable income a corporation may offset with NOL carryforwards. Any unused annual limitation may be carried over to later years until the applicable expiration date for the respective NOL carryforwards.

It is possible that the private placement and the rights offering could trigger an ownership change for purposes of Section 382 of the Internal Revenue Code, which would limit our ability to use any U.S. federal and state NOL carryforwards as described above and could result in a writedown of those assets on our balance sheet and a charge against earnings. Even if the private placement and the rights offering do not trigger an ownership change, they will increase the likelihood that we may undergo an ownership change for purposes of Section 382 in the future.

If you desire to purchase shares in the rights offering, you must act promptly and follow all subscription instructions.

If you desire to purchase shares in the rights offering, you must act promptly to ensure that all required forms and payments are actually received by the subscription agent prior to the expiration date. If you fail to complete and sign the required subscription forms, send an incorrect payment amount, or otherwise fail to follow the subscription procedures that apply to your desired transaction, the subscription agent may, depending on the circumstances, reject your subscription or accept it to the extent of the payment received. Neither we nor the subscription agent undertakes to contact you concerning, or attempt to correct, an incomplete or incorrect subscription form. We have the sole discretion to determine whether the exercise of your rights properly and timely follows the correct procedures.