ELOYALTY CORP
Form DEFS14A
November 14, 2001

Table of Contents

SCHEDULE 14A INFORMATION

Proxy Statement Pursuant to Section 14(a) of the Securities

Exchange Act of 1934 (Amendment No.)

Filed by the Registrant x

Filed by a Party other than the Registrant o

Check the appropriate box:

o Preliminary Proxy Statement
o Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))
x Definitive Proxy Statement
o Definitive Additional Materials
o Soliciting Material Pursuant to Rule 14a-12

eLOYALTY CORPORATION

(Name of Registrant as Specified in Its Charter)

N/A

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

x No fee required.
o Fee computed on table below per Exchange Act Rules 14a-6(i)(4) and 0-11.

(1) Title of each class of securities to which transaction applies:

(2) Aggregate number of securities to which transaction applies:

(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):

(4) Proposed maximum aggregate value of transaction:

(5) Total fee paid:

o Fee paid previously with preliminary materials.

o Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

(1) Amount Previously Paid:

(2) Form, Schedule or Registration Statement No.:

(3) Filing Party:

(4) Date Filed:

TABLE OF CONTENTS

Table of Contents

150 Field Drive, Suite 250

Lake Forest, Illinois 60045

November 14, 2001

Dear eLoyalty Stockholder:

On behalf of the board of directors and management of eLoyalty Corporation, I cordially invite you to attend a special meeting of eLoyalty s stockholders. The special meeting will be held at 9:00 a.m. Central time on December 18, 2001 at our principal executive offices, 150 Field Drive, Suite 250, Lake Forest, Illinois.

At the special meeting, you will be asked to consider and vote on proposals to approve (1) the issuance and sale of up to $25.0 million of 7% Series B convertible preferred stock in a private placement financing; (2) an increase in the number of authorized shares of our common stock and preferred stock in connection with the private placement and the rights offering described herein; and (3) a one-for-ten reverse split of our common stock and a corresponding reduction in the number of authorized shares of common stock.

The accompanying proxy statement contains information about these proposals, and we urge you to read the entire proxy statement carefully.

OUR BOARD OF DIRECTORS SUPPORTS THESE PROPOSALS AND RECOMMENDS THAT OUR STOCKHOLDERS VOTE TO APPROVE EACH OF THEM.

Your vote is important, regardless of the number of shares you own. Whether or not you plan to attend the special meeting, we encourage you to read the accompanying proxy statement and vote promptly. To ensure that your shares are represented at the meeting, whether or not you plan to attend the meeting in person, we urge you to submit a proxy with your voting instructions by telephone, via the Internet or by signing, dating and mailing your proxy card in accordance with the instructions provided on it.

Sincerely,

Kelly D. Conway
President and Chief Executive Officer

Table of Contents

NOTICE OF SPECIAL MEETING OF STOCKHOLDERS

TO BE HELD ON DECEMBER 18, 2001

NOTICE IS HEREBY GIVEN that a special meeting of stockholders of eLoyalty Corporation, a Delaware corporation, will be held at 9:00 a.m. Central time on December 18, 2001 at our principal executive offices, 150 Field Drive, Suite 250, Lake Forest, Illinois, for the following purposes:

1. To approve the issuance and sale by eLoyalty, pursuant to a private placement, of up to $25.0 million of 7% Series B convertible preferred stock pursuant to a share purchase agreement, dated as of September 24, 2001, as the same may be amended from time to time, with several funds affiliated with Technology Crossover Ventures and several funds affiliated with Sutter Hill Ventures, and the issuance of shares of common stock upon the conversion of the Series B convertible preferred stock;

2. To approve an amendment to eLoyalty s Certificate of Incorporation, as amended, to increase the number of authorized shares of common stock, par value $0.01 per share, from 100,000,000 shares to 500,000,000 shares, and to increase the number of authorized shares of preferred stock, par value $0.01 per share, from 10,000,000 shares to 40,000,000 shares;

3. To approve the amendment of eLoyalty s Certificate of Incorporation, as amended, to effect a one-for-ten stock combination, or reverse stock split, with respect to all of the issued shares of eLoyalty common stock and a corresponding reduction in the number of authorized shares of eLoyalty common stock; and

4. To transact such other business as may properly come before the special meeting or any adjournments or postponements thereof.

We will implement Proposals 1 and 2 only if each of Proposals 1, 2 and 3 are approved by our stockholders and are being implemented. If it is approved, we may implement Proposal 3 even if Proposals 1 and 2 are not approved or implemented for any reason.

These proposals are more fully described in the following pages of the proxy statement.

The record date for the special meeting is the close of business on October 22, 2001. Only stockholders of record as of that time and date will be entitled to notice of, and to vote at, the special meeting. A list of the stockholders entitled to vote at the special meeting will be available for inspection at our offices at 150 Field Drive, Suite 250, Lake Forest, Illinois, during normal business hours for ten days prior to the special meeting.

Your vote is important. Stockholders are urged to submit a proxy with their voting instructions as promptly as possible, whether or not they plan to attend the meeting in person. Record holders of eLoyalty shares as of the record date may submit their proxies with voting instructions by using a toll-free telephone number (within North America) or the Internet. Instructions for using these convenient services are set forth on the enclosed proxy card. Of course, you also may submit a proxy containing your voting instructions by completing, signing, dating and returning the enclosed proxy card in the enclosed postage-paid reply envelope.

By Order of the Board of Directors,

Timothy J. Cunningham
Corporate Secretary

Lake Forest, Illinois
November 14, 2001

Table of Contents

TABLE OF CONTENTS

Table of Contents

eLoyalty Corporation
150 Field Drive, Suite 250
Lake Forest, Illinois 60045

PROXY STATEMENT

FOR
A SPECIAL MEETING OF STOCKHOLDERS

TO BE HELD DECEMBER 18, 2001

The board of directors of eLoyalty Corporation is soliciting your proxy for use at a special meeting of stockholders of eLoyalty and any postponements or adjournments thereof. These proxy materials are being mailed to eLoyalty stockholders beginning on or about November 14, 2001.

QUESTIONS AND ANSWERS ABOUT VOTING

Who is entitled to vote at the special meeting?

Holders of record of shares of eLoyalty common stock at the close of business on October 22, 2001 may vote at the special meeting. On that date, 51,712,400 shares of eLoyalty common stock were issued and outstanding and entitled to be voted at the meeting. Each share entitles the holder to one vote.

How do I vote?

If you were a holder of record of eLoyalty common stock (that is, you held your stock in your own name) at the close of business on October 22, 2001, you may submit a proxy with your voting instructions by any of the following methods.

Through the Internet: Go to the web address, http://www.proxyvoting.com/ELOY, and follow the instructions on the proxy card.

By Telephone: Call 1-800-840-1208 on a touch-tone telephone from anywhere within North America and follow the instructions on the proxy card.

By Mail: Complete, sign and mail the proxy card in the enclosed envelope.

If you choose to submit your proxy with voting instructions by telephone or through the Internet, you will be required to provide your assigned control number shown on the enclosed proxy card before your proxy will be accepted. In addition to the instructions that appear on the enclosed proxy card, step-by-step instructions will be provided by recorded telephone message or at the designated Web site on the Internet. Once you have indicated how you want to vote, in accordance with those instructions, you will receive confirmation that your proxy has been successfully submitted by telephone or through the Internet.

If you hold your shares of eLoyalty common stock in street name through a broker, nominee, fiduciary or other custodian, you should check the voting form used by that firm to determine whether you may vote by telephone or through the Internet. If so, use the different toll-free telephone number or Web site address provided on that firm s voting form for its beneficial owners.

How do proxies work?

Giving your proxy means that you authorize the persons named as proxies to vote your shares at the special meeting in the manner you direct. All properly completed and returned proxies will be voted in accordance with the voting instructions given. If you sign and return a proxy card without indicating your voting instructions, they will vote your shares (1) FOR the proposal to approve the issuance and sale, pursuant to a private placement, of shares of 7% Series B convertible preferred stock to Technology Crossover Ventures and Sutter Hill Ventures, and the issuance of shares of common stock upon the conversion of the Series B convertible preferred stock, (2) FOR the proposal to amend the Certificate of Incorporation to increase the

Table of Contents

number of authorized shares of common stock from 100,000,000 shares to 500,000,000 shares and authorized shares of preferred stock from 10,000,000 shares to 40,000,000 shares, and (3) FOR the proposal to amend the Certificate of Incorporation to effect a one-for-ten reverse stock split as described herein. In this proxy, we refer to TCV IV, L.P., TCV IV Strategic Partners, L.P., TCV III (GP), TCV III, L.P., TCV III (Q), L.P. and TCV III Strategic Partners, L.P. and other funds affiliated with Technology Crossover Ventures collectively as Technology Crossover Ventures and we refer to Sutter Hill Ventures, Sutter Hill Entrepreneurs Fund (AI), L.P., Sutter Hill Entrepreneurs Fund (QP), L.P. and Sutter Hill Associates, L.P. and other funds affiliated with Sutter Hill Ventures collectively as Sutter Hill Ventures.

Can I revoke my proxy?

You may revoke your proxy at any time before the voting at the special meeting by any of the following methods:

submitting a new proxy card that is properly signed with a later date;

voting again at a later date by telephone (if you initially voted by telephone) or through the Internet (if you initially voted through the Internet) your most recent voting instructions will be counted and any earlier instructions, using the same procedures, revoked;

sending a properly signed written notice of your revocation to the Corporate Secretary of eLoyalty at 150 Field Drive, Suite 250, Lake Forest, IL 60045; or

voting in person at the special meeting. Attendance at the special meeting will not itself revoke an earlier submitted proxy.

How can I attend the special meeting?

If you are a registered holder of eLoyalty common stock and you plan to attend the special meeting in person, please retain and bring with you the admission ticket attached to the enclosed proxy card. If you hold your shares in street name (in the name of a broker or other nominee) and you do not receive an admission ticket, please bring proof of your ownership of eLoyalty shares with you to the special meeting. A bank or brokerage account statement showing that you owned eLoyalty common stock on October 22, 2001 would be acceptable for this purpose.

How will votes be counted?

The special meeting will be held if a quorum, consisting of a majority of the outstanding shares entitled to vote, is represented in person or by proxy. Abstentions and broker non-votes will be counted as present and entitled to vote for purposes of determining a quorum. A broker non-vote occurs when a nominee, such as a bank or broker, holding shares for a beneficial owner does not vote on a particular proposal because the nominee does not have discretionary voting power with respect to that item and has not received instructions from the beneficial owner.

The rules of the Nasdaq National Market, on which our stock is traded, require stockholders to approve certain substantial sales of common stock or securities convertible into common stock. For this reason, we are asking you to approve the sale of the Series B convertible preferred stock in the private placement. Delaware law requires stockholder approval for the amendments to our Certificate of Incorporation. The votes required for each of the proposals is as described below.

Approval of Proposal 1 requires the affirmative vote of a majority of the outstanding shares of common stock present in person or represented by proxy at the special meeting and entitled to vote. In addition, because Technology Crossover Ventures and Sutter Hill Ventures are significant stockholders of our company and have representatives who are members of our board of directors, we have determined that we will not proceed with Proposal 1 unless it is also approved by the affirmative vote of a majority of the outstanding shares of common stock present or represented at the special meeting and entitled to vote, excluding any votes cast by Technology Crossover Ventures, Sutter Hill Ventures, Jay C. Hoag, who is a member of our board of

Table of Contents

directors and a managing member of the general partner of entities affiliated with Technology Crossover Ventures, Tench Coxe, who is also a member of our board of directors and a managing director of the general partner of Sutter Hill Ventures, and certain of their respective affiliates. Abstentions will be treated as votes against Proposal 1 and broker non-votes will have no effect. Even if it is approved, we will not implement Proposal 1 unless Proposals 2 and 3 are also approved and are being implemented.

The affirmative vote of a majority of the outstanding shares of our common stock entitled to vote at the special meeting is required to approve Proposals 2 and 3. Abstentions and broker non-votes will have the same effect as a vote cast against Proposals 2 and 3. Even if it is approved, we will not implement Proposal 2 unless Proposals 1 and 3 are also approved and are being implemented. We reserve the right to take action on Proposal 3, if it is approved, even if Proposals 1 and 2 are not approved or implemented.

Pursuant to the share purchase agreement we entered into in connection with the private placement, Technology Crossover Ventures and Sutter Hill Ventures have agreed to vote and cause certain of their respective affiliates to vote their shares of eLoyalty common stock (representing approximately 18.5% of the common stock entitled to vote at the special meeting) in favor of each of Proposals 1, 2 and 3. As described above, however, we will not count their votes for purposes of determining whether the private placement has been approved by our disinterested stockholders.

How are proxies being solicited and who will pay for the solicitation of proxies?

We have appointed MacKenzie Partners, Inc., proxy soliciting firm, to solicit proxies for the special meeting. Initially, MacKenzie will solicit proxies by mail. MacKenzie may also solicit proxies in person, by telephone or over the Internet. We will pay all expenses of solicitation of proxies, which are expected to be approximately $20,000. Our directors, officers and other employees may also solicit proxies by telephone, facsimile, and personal interview without additional compensation.

In addition, arrangements will be made with selected banking institutions, brokerage firms, custodians, trustees, nominees and fiduciaries for forwarding solicitation materials and communicating with the beneficial owners of shares held of record by such persons. We will reimburse these persons for their reasonable expenses incurred in connection with such actions.

Who can help answer my other questions?

If you have more questions about voting or wish to obtain another proxy card, you should contact:

MacKenzie Partners, Inc.

(212) 925-5500 (call collect)
(800) 322-2885

PROPOSAL 1: APPROVAL OF THE PRIVATE PLACEMENT

Introduction

We are asking you to approve the issuance and sale, through a private placement, of up to $25.0 million of 7% Series B convertible preferred stock to Technology Crossover Ventures and Sutter Hill Ventures, as well as the issuance of shares of eLoyalty common stock upon conversion of the Series B convertible preferred stock. We have entered into a share purchase agreement with Technology Crossover Ventures and Sutter Hill Ventures regarding the private placement. Technology Crossover Ventures, which currently owns 7,430,440 shares of our common stock, has agreed to purchase up to $15.0 million of Series B convertible preferred stock and Sutter Hill Ventures, which together with certain related entities currently owns 2,123,004 shares of our common stock, has agreed to purchase up to $10.0 million of Series B convertible preferred stock. The purchase price per share of preferred stock will be the lesser of (i) $0.51, and (ii) 90% of the average of the last sales prices of our common stock over the twenty trading days through and including the fourth trading day prior to the closing, subject to adjustment for the proposed one-for-ten reverse split of our common stock described in Proposal 3. If the reverse split is effected as proposed, the purchase price per

Table of Contents

share of preferred stock will be the lesser of $5.10 and 90% of the average price of our common stock on a pre-split basis multiplied by ten.

In connection with the private placement, we are conducting a rights offering in which our existing common stockholders are being offered the right to purchase Series B convertible preferred stock at the same price as the investors in the private placement. The rights will allow our other stockholders to maintain, but not increase, their approximate ownership percentage in eLoyalty immediately prior to the private placement and rights offering, based on the number of shares they held as of the close of business on October 8, 2001, the record date for the rights offering. The investors in the private placement will not participate in the rights offering. However, the closing of the rights offering and the private placement are conditioned on each other and we expect that they would occur simultaneously.

Structure of the Private Placement

The private placement has been structured to comply with restrictions under tax laws that could apply to sales of equity securities by eLoyalty. 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 Series B convertible 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 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.

As a result of these tax restrictions, we have structured the private placement so that neither the voting power nor the value of the shares of common stock held by Technology Crossover Ventures and Sutter Hill Ventures and certain related entities, together with the shares of Series B convertible preferred stock purchased by them in the private placement, may exceed 47% of the total voting power or equity value of eLoyalty. As a result, the maximum amount of Series B convertible 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 (or 2.2 million shares after giving effect to the reverse split of the common stock and the resulting increase in the purchase price per share of the Series B convertible preferred stock), which would result in a maximum of $11.3 million of proceeds, assuming a purchase price of $0.51 per share. If, however, 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 will not know how many shares of preferred stock will be issued in the private placement or the rights offering until the closing, which we expect will occur on December 19, 2001. We do not expect all of the rights to be exercised. If they were, however, we expect that the maximum number of shares of Series B convertible preferred stock issuable in connection with the private placement and the rights offering would be between approximately 171 million shares, assuming a purchase price of $0.51 per share (or 17.1 million shares at a post-split purchase price of $5.10 per share), and approximately 248 million shares, assuming a purchase price of $0.35 per share or less (or 24.8 million shares at a post-split purchase price of $3.50 or less), and subject to the further assumptions described below. Because we believe it is unlikely that the rights will be fully exercised, we expect to issue fewer shares of preferred stock in the private placement and rights offering than the maximum number possible.

Given the number of shares of preferred stock that may be issued (and the number of shares of common stock that would be issued upon conversion of the preferred stock), we are also seeking approval of Proposal 2 to increase the number of shares of common stock and preferred stock we are authorized to issue. We are also seeking approval of Proposal 3 to effect a reverse split of our common stock to rationalize our resulting equity capital structure. If Proposals 1, 2 and 3 are all approved, we would first implement the increase in our share capital as described in Proposal 2, then implement the reverse stock split as described in Proposal 3. After the reverse split is effected, the closing of the private placement and the rights offering would occur. Because the

Table of Contents

closing will be after the effective date of the reverse split, the purchase price per share of the Series B convertible preferred stock will be adjusted by multiplying the purchase price by ten, resulting in a corresponding decrease in the number of shares of preferred stock to be issued. Each share of preferred stock will be convertible into one share of post-split common stock beginning six months after the closing of the private placement and the rights offering.

Under the terms of the share purchase agreement, Technology Crossover Ventures and Sutter Hill Ventures cannot exercise their rights in the rights offering. In addition, rights issued in respect of restricted stock held by our officers and employees that has not vested on or prior to the closing date cannot be exercised. As a result, the information in this proxy statement related to 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. The information in this proxy statement also assumes that all of the rights that are exercised are exercised in full, which means that the holder elects to subscribe for $1.60 of preferred stock per right. However, stockholders who receive rights will have the option to subscribe for $1.60, $1.00 or $0.50 of preferred stock per right. The number of shares of preferred stock issued in the private placement and the rights offering may be less if rights are exercised for less than the full amount.

In addition, we have assumed for purposes of this proxy statement that the value of our common stock on the closing date will be at least equal to 83.3% of the purchase price of the preferred stock (which would result in a value of the preferred stock for purposes of the tax restrictions described above being no more than 120% of the value of the common stock). If the value of our common stock is less than 83.3% of the purchase price of the preferred stock, the number of shares issued in the private placement and the rights offering may decrease.

The information in this proxy statement also gives effect to the issuance of approximately 5.7 million shares of common stock (570,000 shares after giving effect to the reverse stock split) in connection with an offer we made to our employees to exchange some of their outstanding options for shares of restricted common 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.

Nasdaq Stockholder Approval Requirement

Our common stock is listed on The Nasdaq National Market. The rules governing companies with securities listed on Nasdaq require stockholder approval in connection with a transaction other than a public offering involving the sale or issuance by the issuer of common stock (or securities convertible into or exchangeable for common stock) equal to 20% or more of the common stock or 20% or more of the voting power outstanding before the issuance for less than the greater of book or market value of the stock. This requirement is set forth in Nasdaq Marketplace Rule 4350(i)(1)(D). In addition, stockholder approval is required under Nasdaq Marketplace Rule 4350(i)(1)(B) in connection with the issuance of securities that could result in a change of control of an issuer.

Because the private placement described in this Proposal 1 involves the potential issuance by eLoyalty of securities convertible into shares of common stock that would represent more than 20% of the currently outstanding common stock at below the greater of book or market value of the common stock, and because it could also potentially result in issuances resulting in a change of control for Nasdaq purposes, stockholder approval is required before the investors in the private placement could convert shares of Series B convertible preferred stock into shares of common stock representing 20% or more our outstanding common stock.

Reasons for the Private Placement

The principal reasons for seeking additional financing are to strengthen our balance sheet and to assure our customers and potential customers that we have sufficient financial resources to successfully complete the projects that we are competing for, which are generally complex and relatively long-term. We believe that obtaining additional capital is critical to our ability to continue to execute on our business plan during

Table of Contents

uncertain or difficult economic conditions and to sustain the confidence of our customers, business partners and employees. We also believe that a sale of our securities in the public markets at the current market price of our common stock is not likely to be achievable, given current conditions in the market for public company issuances, particularly for companies in our industry. Further, we believe that a public offering could present the same issues regarding our tax-free spin-off from TSC as are described above with respect to the private placement, but afford us less opportunity to address these issues through the transaction structure. The board of directors and management of eLoyalty considered a number of financing alternatives prior to entering into the share purchase agreement for the private placement. We believe that the best option for additional financing is to complete the private placement and the rights offering.

Background to the Private Placement

In June 2001, eLoyalty s management began to explore possible means of obtaining additional financing for its business. During this time period, eLoyalty learned that Technology Crossover Ventures, an existing stockholder who has a representative on eLoyalty s board of directors, might be interested in making an additional equity investment in eLoyalty. In late June 2001, eLoyalty s management continued to explore whether Technology Crossover Ventures or other investors, including other existing stockholders of eLoyalty, would be interested in making a financing proposal to eLoyalty.

On July 3, 2001, a special meeting of the board of directors of eLoyalty was held. At this meeting, the board of directors discussed the desirability of exploring a possible equity financing and discussed the possibility that Technology Crossover Ventures and/ or Sutter Hill Ventures, another existing stockholder of eLoyalty with a representative on the board of directors, would be interested in making an additional investment in eLoyalty. The board of directors of eLoyalty determined that it would be desirable to establish a special committee of the board of directors for the purpose of further exploring the company s financing alternatives. Outside directors John T. Kohler and John R. Purcell expressed a willingness to serve on such a special committee. Accordingly, the board of directors authorized the creation of a special committee of the board of directors consisting of Messrs. Kohler and Purcell and authorized the special committee to evaluate potential financing alternatives and to make a recommendation to the board of directors regarding those alternatives.

On July 5, 2001, the special committee held a meeting at which it determined to retain legal counsel and discussed the retention of a financial advisor. At this meeting, the special committee discussed the company s cash needs with members of management and discussed the means likely to be available to the company to raise the desired financing.

On July 12, 2001, the special committee held a meeting at which it discussed the possibility of seeking financing proposals from existing eLoyalty stockholders, Technology Crossover Ventures and Sutter Hill Ventures. The special committee determined to request that Technology Crossover Ventures and Sutter Hill Ventures each submit proposals setting forth the terms upon which they would be prepared to make additional equity investments in eLoyalty. The special committee also discussed the status of negotiations regarding the retention of a financial advisor. Following that meeting, a representative of the special committee separately contacted Technology Crossover Ventures and Sutter Hill Ventures to request that each of them submit a proposal to the special committee if either of them were interested in making an additional investment in eLoyalty.

On July 17, 2001, Technology Crossover Ventures submitted a proposal to invest $15 million of its own funds to purchase shares of convertible preferred stock and warrants of eLoyalty in a financing round that would raise a total of $30 million in proceeds.

On July 19, 2001, the special committee held a meeting at which it discussed the financing proposal that had been received from Technology Crossover Ventures. The special committee also discussed the retention of a financial advisor and determined to engage Deutsche Banc Alex. Brown Inc. to act as its financial advisor.

On July 25 and July 26, 2001, the special committee held meetings at which it further discussed the company s financing needs and its strategic financing alternatives, including the Technology Crossover

Table of Contents

Ventures financing proposal, with Deutsche Banc Alex. Brown and the special committee s legal advisors. At these meetings, Deutsche Banc Alex. Brown reported to the special committee regarding meetings it had with members of eLoyalty s senior management and discussed with the special committee its review of the company s expected cash needs relative to its available cash resources. During this time period, Deutsche Banc Alex. Brown engaged in discussions with Technology Crossover Ventures regarding its proposal and reported to the special committee regarding those discussions. On July 31, 2001, Technology Crossover Ventures submitted a revised financing proposal in response to the discussions between it and Deutsche Banc Alex. Brown. The July 31 Technology Crossover Ventures proposal called for a series of transactions that would raise between $30 million and $40 million in proceeds to eLoyalty.

On August 1, August 2 and August 6, 2001, the special committee held meetings at which it discussed the revised Technology Crossover Ventures proposal with Deutsche Banc Alex. Brown and the special committee s legal advisors. At these meetings, the special committee continued to discuss the company s cash needs and the possible alternatives that might be available to the company, including the preliminary results of Deutsche Banc Alex. Brown s efforts to contact alternative equity financing sources regarding their possible interest in an investment in the company. During this time period, the special committee also discussed the possible federal income tax implications of any financing transaction in light of eLoyalty s spin-off from Technology Solutions Company in 2000, including the possible limitations this would impose on the ability of the company to effect the transactions contemplated by the Technology Crossover Ventures proposals.

On August 2, 2001, eLoyalty was notified by Nasdaq that it risked being delisted from the Nasdaq National Market if the bid price for its common stock did not exceed $1.00 for at least 10 consecutive days prior to October 31, 2001.

On August 7, 2001, a meeting of the board of directors of eLoyalty was held. At this meeting, the members of the special committee reported to the board of directors on its deliberations and negotiations to date. The board of directors also discussed the merits of a possible reverse stock split and alternatives for establishing appropriate equity-based incentives for the company s employees.

On August 9, 2001, Mr. Purcell resigned as a director of eLoyalty for personal reasons.

On August 13, 2001, a meeting of the board of directors of eLoyalty was held. At this meeting, the board of directors discussed Mr. Purcell s resignation and its implications for the advisability of continuing with the process established with the special committee. After consulting with its legal counsel, the board of directors concluded that a special committee consisting of only one director was unlikely to serve the best interests of the company and its stockholders. The board of directors also concluded that, due to the current composition of the board of directors, a special committee with a sufficient number of directors without any actual or perceived interest in the transactions under consideration might not be feasible. At the request of the board of directors, directors Jay Hoag and Tench Coxe, who are principals in Technology Crossover Ventures and Sutter Hill Ventures, respectively, then recused themselves from the meeting. The board of directors then discussed the advisability of conducting a rights offering which would provide the other stockholders of the company with the opportunity to participate in any investment on terms substantially similar to those offered to Technology Crossover Ventures and Sutter Hill Ventures, as had been under consideration by the special committee. The board of directors also discussed the advisability of requiring that any private placement with Technology Crossover Ventures and Sutter Hill Ventures be approved by a majority of disinterested stockholders present and entitled to vote at a special meeting called to approve such transaction. After considering all these factors, the board of directors concluded that the company s financing alternatives should be addressed in the future by the board of directors as a whole, subject to recusal of Messrs. Hoag and Coxe as appropriate.

On August 14, 2001, Technology Crossover Ventures submitted a revised financing proposal intended to address the limitations on the amount that it could invest in eLoyalty in light of the restrictions imposed by the federal tax laws related to the 2000 spin-off of eLoyalty. The August 14 proposal called for a $25 million private placement, consisting of $15 million in convertible preferred stock and warrants and $10 million in subordinated notes of eLoyalty, and a simultaneous rights offering of up to $15 million in convertible preferred stock and warrants of eLoyalty to be made available to the stockholders of eLoyalty other than the investors in

Table of Contents

the private placement. Based on Technology Crossover Ventures understanding that eLoyalty s board of directors would insist on substantive and procedural protections for eLoyalty s disinterested stockholders, this revised proposal contemplated not only a rights offering that would allow disinterested stockholders to make additional investments on similar terms, but also a concession by Technology Crossover Ventures that any transaction would be conditioned on the prior approval of eLoyalty s stockholders, including a majority of eLoyalty s disinterested stockholders present or represented at the special meeting and entitled to vote.

On August 15, August 17 and August 21, 2001, the board of directors of eLoyalty held meetings at which it discussed the revised Technology Crossover Ventures proposal, the federal tax considerations related to possible financing transactions and the possible timing for such transactions. The board of directors also discussed a possible reverse stock split and alternatives for re-establishing meaningful equity-based incentives for the company s employees. At the request of the board of directors, Messrs. Coxe and Hoag recused themselves from a portion of these meetings to permit the other directors of eLoyalty to discuss these matters without their participation. During the portion of these meetings in which Messrs. Coxe and Hoag were not present, Deutsche Banc Alex. Brown confirmed that its ongoing efforts to attract alternative equity financing sources had yielded no positive results.

On August 30, 2001, Technology Crossover Ventures submitted a further revised financing proposal intended to address continuing concerns about the limitations imposed by the federal tax laws in light of the 2000 spin-off transaction. This proposal called for a $25 million private placement of convertible preferred stock of eLoyalty and a simultaneous rights offering of up to $20 million in convertible preferred stock of eLoyalty to be made available to the stockholders of eLoyalty other than the investors in the private placement.

On August 31, 2001, the board of directors of eLoyalty held a meeting at which it discussed the latest financing proposal from Technology Crossover Ventures and the financial and tax implications of that proposal. At the request of the board of directors, Messrs. Coxe and Hoag recused themselves from a portion of this meeting to permit the other directors of eLoyalty to discuss these matters without their participation.

On September 7, 2001, the board of directors of eLoyalty held a meeting at which the board of directors reviewed the proposed private placement, rights offering and reverse stock split and a proposal to establish appropriate equity-based incentives for the company s employees. After the board of directors discussed its fiduciary duties under applicable law with its legal advisers, representatives of Deutsche Banc Alex. Brown reviewed with the board of directors Deutsche Banc Alex. Brown s overview of the information technology services sector and the company s situation (including, based on information received from the company, its outlook, its foreseeable cash needs and sources of liquidity as compared with other companies, and certain related events, such as the notification the company received from the Nasdaq National Market that the company has failed to maintain Nasdaq s minimum bid price of $1.00 per share). Deutsche Banc Alex. Brown also reviewed with the board of directors the advantages, disadvantages and anticipated feasibility, in light of timing and other considerations, of various financing alternatives and the proposed private placement, rights offering and reverse stock split. Lastly, Deutsche Banc Alex. Brown confirmed that its ongoing efforts to attract alternative equity funding sources had not yielded any positive results. After these discussions, Messrs. Coxe and Hoag recused themselves from the meeting to permit the board of directors to deliberate without their participation.

Discussions and negotiations regarding the terms of the proposed transactions continued throughout early and mid-September. During the course of these negotiations the proposed $20 million limitation on the size of the rights offering was eliminated from the proposal at eLoyalty s request.

On September 17 and September 20, 2001, the board of directors held meetings to review the status of negotiations regarding the terms of the proposed transactions and the status of preparation and negotiation of a definitive private placement agreement and related documents. During this time period, members of our senior management held individual meetings with each of our directors to explain and discuss the terms of the proposed transactions.

Table of Contents

On September 24, 2001, the board of directors met to further discuss the matters addressed at the earlier September meetings. At this meeting, Deutsche Banc Alex. Brown representatives reviewed their analyses of the proposed transactions and rendered their written opinion to the board of directors to the effect that, as of that date and based upon and subject to the assumptions made, matters considered and limits of the review undertaken by Deutsche Banc Alex. Brown, the private placement and rights offering were fair, from a financial point of view, to eLoyalty s stockholders. Following their deliberations, the board of directors unanimously resolved, with directors Coxe and Hoag abstaining as to the private placement and certain related items, to approve the matters referred to in Proposals 1, 2 and 3 and to recommend that stockholders of eLoyalty vote to approve those matters. The board of directors also unanimously resolved, with directors Coxe and Hoag abstaining, to authorize the acquisition of additional shares of eLoyalty voting stock by Technology Crossover Ventures and Sutter Hill Ventures for purposes of Section 203 of the Delaware General Corporation Law and to amend eLoyalty s rights agreement, dated March 17, 2000 (the Rights Agreement), to permit such acquisition without adverse effect under that agreement.

Opinion of Financial Advisor to the Board of Directors

We engaged Deutsche Banc Alex. Brown to render an opinion as to the fairness to our stockholders, from a financial point of view, of the proposed private placement of Series B convertible preferred stock and offering of rights to purchase Series B convertible preferred stock. At the September 7, 2001 meeting of our board of directors, Deutsche Banc Alex. Brown reviewed analyses related to the proposed transactions. On September 24, 2001, Deutsche Banc Alex. Brown delivered its opinion in writing to our board of directors to the effect that, as of that date and based upon and subject to the assumptions made, matters considered and limits of the review undertaken by Deutsche Banc Alex. Brown, the transactions were fair, from a financial point of view, to our stockholders.

The full text of Deutsche Banc Alex. Brown s written opinion, dated as of September 24, 2001, which sets forth, among other things, the assumptions made, matters considered and limits of the review undertaken by Deutsche Banc Alex. Brown in connection with the opinion, is attached as Appendix A to this proxy statement and is incorporated herein by reference. You are urged to read the Deutsche Banc Alex. Brown opinion in its entirety. The summary of the opinion of Deutsche Banc Alex. Brown set forth in this proxy statement is qualified in its entirety by reference to the full text of the opinion, attached hereto as Appendix A.

Deutsche Banc Alex. Brown s opinion was directed only to our board of directors. The opinion is not a recommendation to our stockholders to approve the transactions or participate in the rights offering and it is limited to the fairness to our stockholders, from a financial point of view, of the transactions. In rendering its opinion, Deutsche Banc Alex. Brown expressed no opinion as to the merits of the underlying decision by us to engage in the transactions or any alternative transaction. The terms of the transactions were determined through arm s-length negotiations between Technology Crossover Ventures and Sutter Hill Ventures and us and were approved by our board of directors (with our two directors who are affiliated with the private placement investors abstaining with respect to the private placement and certain related items). The opinion and presentations of Deutsche Banc Alex. Brown were only one of a number of factors taken into consideration by our board of directors in making its determination to approve the transactions. Deutsche Banc Alex. Brown also did not express any opinion as to the prices at which any class of our stock will trade at any time.

In connection with its role as our financial advisor, and in arriving at its opinion, Deutsche Banc Alex. Brown:

- reviewed certain publicly available financial and other information concerning us and certain internal analyses and other information that we furnished to Deutsche Banc Alex. Brown;
- held discussions with members of our senior management regarding our business and prospects;
- reviewed the reported prices and trading activity for our common stock;
- reviewed the terms of certain comparable private investments in public equity securities and compared the terms of these transactions to the terms of our Series B convertible preferred stock;

Table of Contents

compared our financial and stock market information with similar information for certain other companies whose securities are publicly traded;

made inquiries regarding and discussed the transactions and the terms of the transaction documents with our senior management and our counsel;

made inquiries of various potential private equity investors regarding their interest in investing in us; and

performed such other studies and analyses and considered such other factors as Deutsche Banc Alex. Brown deemed appropriate.

For purposes of rendering its opinion, Deutsche Banc Alex. Brown assumed that:

the holders of a majority of our common stock present or represented at the special meeting of stockholders described in this proxy statement, other than Technology Crossover Ventures and Sutter Hill Ventures, will approve the transactions;

the rights offering will afford eLoyalty s stockholders the right to purchase sufficient shares of preferred stock so as to maintain each such stockholder s approximate percentage ownership in eLoyalty, with the understanding that Technology Crossover Ventures and Sutter Hill Ventures have agreed not to exercise such rights with respect to any shares of common stock held by them and that the holders of non-vested restricted shares of common stock of eLoyalty will agree not to exercise such rights with respect to such shares;

based entirely on our advice and the advice of our advisors, the transactions as presented to Deutsche Banc Alex. Brown will not adversely affect the tax-free nature of our February 2000 100% tax-free spin off and it is Deutsche Banc Alex. Brown s understanding that the consummation of the transactions is conditioned upon our receipt of an opinion of our counsel to such effect;

all material governmental, regulatory or other consents and approvals necessary to the consummation of the transactions will be obtained without any material adverse impact on us or on the contemplated benefits to us of the transactions;

in all respects material to its analysis, the representations and warranties made by Technology Crossover Ventures, Sutter Hill Ventures and us in the documents executed in connection with the transactions are true and correct and that each of these parties will perform all of the covenants and agreements to be performed by it under such documents;

in all respects material to its analysis, all conditions to the obligation of each of Technology Crossover Ventures, Sutter Hill Ventures and us to consummate the transactions will be satisfied without any waiver of them;

the transactions will be consummated in a manner that complies in all respects with the applicable provisions of the Securities Act of 1933, as amended, the Securities Exchange Act of 1934, as amended, and all other applicable federal and state statutes, rules and regulations; and

the transaction documents, this proxy statement and the registration statement filed in connection with the rights offering are consistent with eLoyalty s description of these documents to Deutsche Banc Alex. Brown and this proxy statement and such registration statement accurately describe the transactions, the preferred stock, the rights and the transaction documents in all material respects.

In connection with its review, Deutsche Banc Alex. Brown relied on (i) the advice of our counsel as to all legal matters concerning us and (ii) information provided by us and publicly available information as to certain financial matters concerning us. Deutsche Banc Alex. Brown also did not assume responsibility for independent verification of, and did not independently verify, any public or private information furnished to it such as, for example, any financial information, forecasts or projections that it considered in connection with rendering its opinion. Deutsche Banc Alex. Brown assumed and relied upon the accuracy and completeness of such information and did not conduct a physical inspection of any of our properties or assets, nor did Deutsche

Table of Contents

Banc Alex. Brown prepare or obtain any independent evaluation or appraisal of any of our assets or liabilities. Deutsche Banc Alex. Brown assumed that all financial forecasts and projections made available to it and used in its analyses were reasonably prepared on bases reflecting the best currently available estimates and judgments of our management as to the matters that such financial forecasts and projections covered. In rendering its opinion, Deutsche Banc Alex. Brown expressed no view as to the reasonableness of such forecasts and projections or the assumptions on which they were based and considered our management s assessment of our financing requirements, the availability of alternative financing and the potential effects on us and our business of a failure to obtain additional capital in the near term.

Deutsche Banc Alex. Brown s opinion is necessarily based upon economic, market and other conditions as in effect on, and the information made available to it as of, the date of its opinion and events occurring after the date of its opinion could materially affect the assumptions Deutsche Banc Alex. Brown used in preparing its opinion. Deutsche Banc Alex. Brown has assumed no obligation to update, revise or reaffirm its opinion. Deutsche Banc Alex. Brown further assumed that the terms of the transactions were the most beneficial terms from our perspective that under the circumstances could be negotiated among the parties to the transactions and Deutsche Banc Alex. Brown expressed no opinion as to whether any alternative transaction might produce proceeds to us in an amount in excess of that to be received by us in the currently proposed transactions. At our request, Deutsche Banc Alex. Brown did not engage in any discussions with any third parties regarding a merger or any other potential business combination involving eLoyalty.

We paid Deutsche Banc Alex. Brown fees for its services as financial advisor to us in connection with the transactions, including a fee in connection with the delivery of its opinion, and we will pay Deutsche Banc Alex. Brown additional financial advisory fees in the future. Deutsche Banc Alex. Brown is an affiliate of Deutsche Bank AG (together with its affiliates, the DB Group). In the ordinary course of business, members of the DB Group may actively trade in our securities and other instruments and obligations of us for their own accounts and for the accounts of their customers. Accordingly, the DB Group may at any time hold a long or short position in such securities, instruments and obligations. In addition, the DB Group may have investment banking, financial advisory and other relationships with parties other than us pursuant to which the DB Group may acquire information of interest to us and our board of directors. Deutsche Banc Alex. Brown has no obligation to disclose such information to us or our board of directors, nor did it have any obligation to use such information in the preparation of its fairness opinion.

DB Alex. Brown Venture Investors Fund, an affiliate of Deutsche Banc Alex. Brown, is an investor in TCV IV, L.P., which is a holder of a significant number of shares of our common stock and an investor in the private placement. One or more employees of Deutsche Banc Alex. Brown who have provided advisory and investment banking services to us and our board of directors are investors in DB Alex. Brown Venture Investors Fund.

Interests of Certain Persons in the Investment

Mr. Coxe, the chairman of eLoyalty s board of directors, is a managing director of the general partner of the various funds affiliated with Sutter Hill Ventures that have agreed to invest in the private placement. Mr. Hoag, also an eLoyalty director, is a general partner of Technology Crossover Ventures, and one of two managing members of each of the limited liability companies that serves as the general partner to the various funds affiliated with Technology Crossover Ventures that have agreed to invest in the private placement. As disclosed under Security Ownership of Certain Beneficial Owners and Management, as of November 1, 2001, as a result of their respective affiliations with Technology Crossover Ventures and Sutter Hill Ventures, Messrs. Hoag and Coxe may be deemed to beneficially own approximately 14.39% and 4.14%, respectively, of the then-outstanding eLoyalty common stock. In addition, Sutter Hill Ventures L.P. and various Technology Crossover Ventures funds have agreed with eLoyalty and a fund affiliated with Bain Capital to participate in a venture fund, eLoyalty Ventures, L.L.C., to be sponsored by eLoyalty. Pursuant to an operating agreement providing for the formation, management and operation of this fund, each of Sutter Hill Ventures L.P. and such Technology Crossover Ventures funds (considered together) have made a capital commitment of $5.1 million (each representing approximately 17% of the total committed capital) to eLoyalty Ventures. eLoyalty, through a limited liability company in which it and certain of its officers are expected to invest, has

Table of Contents

made a capital commitment to eLoyalty Ventures of $14.7 million (or approximately 49% of the total committed capital).

In addition, Kelly D. Conway, eLoyalty s President and Chief Executive Officer and a director, holds a limited partnership investment in a fund of Technology Crossover Ventures, TCV IV, L.P., representing a total commitment of $1,000,000, of which $477,300 has been funded as of the date of this proxy statement, and a limited partnership investment in Sutter Hill Entrepreneurs Fund (QP), L.P. representing a commitment of $50,000, of which $32,500 has been funded as of the date of this proxy statement. Michael J. Murray, a director of eLoyalty, holds a limited partnership investment in TCV IV, L.P. representing a total commitment of $3,000,000, of which $1,431,900 has been funded as of the date of this proxy statement. Mr. Coxe holds a 20% investment in Page Mill Partners III and an 18% investment in Page Mill Partners IV, investors in TCV III, L.P. and TCV IV, L.P., respectively, representing total commitments of $1,000,000 and $1,900,000, respectively, of which $1,000,000 and $890,720 has been funded as of the date of this proxy statement.

Required Vote

Approval of the private placement described in this Proposal 1 requires the affirmative vote of a majority of the outstanding shares of common stock present in person or represented by proxy at the special meeting and entitled to vote. In addition, because Technology Crossover Ventures and Sutter Hill Ventures are significant stockholders of our company and have representatives who are members of our board of directors, we have determined that we will not proceed with Proposal 1 unless it is also approved by a majority of the outstanding shares of common stock present or represented at the special meeting and entitled to vote, excluding any votes cast by Technology Crossover Ventures, Sutter Hill Ventures, Messrs. Hoag and Coxe and certain of their respective affiliates. Abstentions will be treated as votes against the proposal and broker non-votes will have no effect. Even if it is approved, we will not implement the private placement unless the increase in our authorized capital stock described in Proposal 2 and the reverse stock split described in Proposal 3 are also approved and are being implemented.

Pursuant to the share purchase agreement, Technology Crossover Ventures and Sutter Hill Ventures have agreed to vote and cause certain of their respective affiliates to vote their shares of eLoyalty common stock (representing approximately 18.5% of the common stock entitled to vote at the special meeting) in favor of this proposal. As described above, however, we will not count their votes for purposes of determining whether the private placement has been approved by our disinterested stockholders.

Recommendation of the Board of Directors

The board of directors has approved the matters included in Proposal 1 and believes that they are fair to, and in the best interests of, us and our stockholders. The board recommends that stockholders vote FOR Proposal 1.

Effect of the Proposed Investment by Technology Crossover Ventures and Sutter Hill Ventures

The amount of proceeds we will raise from the private placement and the rights offering depends on the number of and extent to which the rights are exercised. If every stockholder that is eligible to exercise rights exercises their rights in full, the maximum proceeds from the private placement and the rights offering would be approximately $87.0 million. It is unlikely that all eligible stockholders will fully exercise their rights. Assuming the purchase price for the Series B convertible preferred stock is the maximum of $0.51 per share ($5.10 after giving effect to the proposed reverse stock split), total proceeds to eLoyalty from the private placement and rights offering would be (i) $13.0 million and $2.2 million, respectively, assuming 20% of the rights are exercised in full, (ii) $18.9 million and $14.1 million, respectively, assuming 60% of the rights are exercised in full, and (iii) $25.0 million and $62.0 million, respectively, assuming 100% of the rights are exercised in full. The total proceeds may be less if the purchase price is less than the maximum of $0.51 per share.

Table of Contents

The issuance of the Series B convertible preferred stock in the private placement and the rights offering may result in substantial dilution of your ownership interest in eLoyalty, particularly if you are not eligible to participate (for example, if you did not own our common stock at the close of business on October 8, 2001, the record date for the rights offering), or you elect not to participate, in the rights offering. It may also result in a substantial decrease in your net book value per share. For example, if a stockholder owns 100,000 shares of common stock before the rights offering (which would be 10,000 shares after giving effect to the reverse stock split), or approximately 0.17% of our common stock, and does not exercise his or her rights while all other rights are exercised in full, then his or her percentage ownership in our equity will be reduced to 0.04% upon completion of the transactions. The extent of such dilution will depend upon the price at which the Series B convertible preferred stock is sold and the level of stockholder participation in the rights offering.

The percentage ownership of Technology Crossover Ventures and Sutter Hill Ventures in our company will increase as a result of the private placement. This 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 approval of 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 (570,000 shares after giving effect to the reverse stock split) of common stock in connection with an offer we made to our officers and employees to exchange options for common stock as well as the other assumptions described under the caption Structure of the Private Placement above. In connection with the private placement, we have amended our Rights Agreement to allow Technology Crossover Ventures to acquire up to 35% of our outstanding common stock, and Sutter Hill Ventures to acquire up to 20% of our outstanding common stock, without any adverse effects under the Rights Agreement.

Technology Crossover Ventures and Sutter Hill Ventures, as holders of the Series B convertible preferred stock, will have the rights and preferences described in this proxy statement, including the right to vote together with the holders of the common stock on an as-converted basis. In addition, the holders of the Series B convertible preferred stock will have dividend rights that are senior to those of the holders of our common stock. The holders of the Series B convertible preferred stock will also have a claim against our assets senior to the claim of the holders of the common stock in the event of our liquidation or bankruptcy. Initially, the aggregate amount of the senior claims of the holders of the Series B convertible preferred stock will equal the amount invested to purchase the Series B convertible preferred stock and may increase thereafter due to the accumulation of dividends on the Series B convertible preferred stock.

The holders of the Series B convertible preferred stock will also have the right to consent to a number of other significant corporate transactions, including the sale of eLoyalty within six months of the closing of the private placement, the authorization or issuance of securities convertible into or exercisable for equity securities of eLoyalty with rights or preferences equal or superior to the Series B convertible preferred stock, and amendments to the Certificate of Incorporation that would otherwise adversely effect the rights of holders of Series B convertible preferred stock. Technology Crossover Ventures and Sutter Hill Ventures currently have significant investments in other technology solutions companies. As a result, they may have interests with respect to their investment in us that differ from those of other stockholders.

The ownership by Technology Crossover Ventures and Sutter Hill Ventures and their affiliates of a substantial percentage of our total voting power and the terms of the Series B convertible preferred stock could make it more difficult and expensive for a third party to pursue a change of control of eLoyalty, even if a change of control would generally be beneficial to the interests of our stockholders.

Sales in the public market of the common stock acquired upon conversion of Series B convertible preferred stock could lower our stock price and impair our ability to raise funds in additional stock offerings. Future sales of a substantial number of shares of our common stock in the public market, or the perception

Table of Contents

that such sales could occur, could adversely affect the prevailing market price of our common stock and could make it more difficult for us to raise funds through a public offering of our equity securities.

In addition, the private placement may jeopardize our future ability to use certain net operating loss carryforwards. At September 29, 2001, we had incurred significant operating losses in the United States for the year to date. 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 these NOL carryforwards could become subject to significant limitations under Section 382 of the Internal Revenue Code, as amended, 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, as amended, 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.

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, 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 for 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 Internal Revenue Service 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.

In connection with the sale of Series B convertible preferred stock, we will enter into an investor rights agreement with Technology Crossover Ventures and Sutter Hill Ventures that will obligate us to register the shares of common stock issuable upon conversion of the Series B convertible preferred stock within 180 days after the closing of the private placement. We will also grant Technology Crossover Ventures and Sutter Hill Ventures piggyback registration rights to participate in underwritten offerings of our securities. The exercise of

Table of Contents

these piggyback registration rights will be subject to notice requirements, timing restrictions and volume limitations which may be imposed by the underwriters of an offering. These registration rights are described in further detail under the heading The Share Purchase Agreement Investor Rights Agreement.

The Share Purchase Agreement

General

On September 24, 2001, we entered into a share purchase agreement with Technology Crossover Ventures and Sutter Hill Ventures pursuant to which Technology Crossover Ventures has agreed to purchase up to $15 million, and Sutter Hill Ventures has agreed to purchase up to $10 million, of 7% Series B convertible preferred stock. Sutter Hill Ventures has requested we amend the share purchase agreement to revise the allocation of share purchase commitments among various of the participating Sutter Hill Ventures funds, without changing the overall financing commitment of Sutter Hill Ventures. We expect to do this as soon as practicable after the date of this proxy statement. At closing, we will enter into an amended and restated investor rights agreement that will provide registration rights with respect to the shares of common stock issuable upon conversion of the Series B convertible preferred stock issued in the private placement as well as certain other shares owned by Technology Crossover Ventures. The following discussion of the share purchase agreement and amended and restated investor rights agreement, and the transactions contemplated thereby, provide only a summary. For a more complete understanding of these agreements, we urge you to read our Form 8-K filed with the Securities and Exchange Commission (SEC) and dated September 24, 2001, including the share purchase agreement and form of amended and restated investor rights agreement which are filed as exhibits thereto.

Price

The purchase price per share of preferred stock will be the lesser of (i) $0.51, and (ii) 90% of the average of the last sales prices of our common stock over the twenty trading days through and including the fourth trading day prior to the closing, subject to adjustment for the proposed one-for-ten reverse split of our 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 our common stock on a pre-split basis multiplied by ten.

Representations, Warranties, Covenants and Agreements

The share purchase agreement contains representations and warranties by us relating to, among other things, our capitalization and due authorization, the issuance and sale of the Series B convertible preferred stock, our SEC filings and our lack of undisclosed liabilities and material adverse changes. The share purchase agreement also contains representations and warranties by the investors relating to, among other things, their status as accredited investors and investment intent.

We and Technology Crossover Ventures and Sutter Hill Ventures have agreed to use our respective reasonable best efforts to satisfy the conditions to closing of the private placement, including obtaining any necessary regulatory approvals. We have also agreed to conduct the rights offering, hold this special meeting and to not take specified actions with respect to our capital stock, Certificate of Incorporation and by-laws prior to closing. Technology Crossover Ventures and Sutter Hill Ventures have agreed to vote their shares of common stock in favor of the proposals described in this proxy statement, not exercise any rights received in the rights offering and not purchase or dispose of shares of our common stock for specified periods.

In connection with the share purchase agreement, we have amended our Rights Agreement to permit Technology Crossover Ventures to acquire up to 35% of our outstanding common stock and to permit Sutter Hill Ventures to acquire up to 20% of our outstanding common stock without adverse effect under the Rights Agreement.

Table of Contents

Conditions to Closing

The closing of the private placement is conditioned on the satisfaction or waiver of various conditions, including the accuracy of the representations and warranties included in the share purchase agreement as of closing, each party s compliance with its covenants and agreements in the share purchase agreement prior to closing, our receipt of a favorable opinion of tax counsel that the private placement and rights offering will not cause our spin-off from TSC to be taxable to TSC, our receipt of an opinion of Deutsche Banc Alex. Brown stating that, as of September 24, 2001 (and based upon and subject to the assumptions made, matters considered and limits of the review undertaken by Deutsche Banc. Alex Brown), the private placement and rights offering were fair, from a financial point of view, to our stockholders (and the lack of any withdrawal or modification of that opinion), approval of the proposals described in this proxy statement by our stockholders, the absence of regulatory constraints and the delivery of customary closing documents. In addition, the obligations of Technology Crossover Ventures and Sutter Hill Ventures to effect the closing are conditioned on our listing the shares of common stock to be issued upon conversion of the Series B convertible preferred stock on Nasdaq and the absence of any material adverse change to our company since the date of the share purchase agreement. Our obligations to effect the closing are also conditioned on a concurrent closing of the rights offering.

Investor Rights Agreement

In connection with the closing of the private placement, we will enter into an amended and restated investor rights agreement with Technology Crossover Ventures and Sutter Hill Ventures. The agreement will require us to use our reasonable best efforts to have a registration statement on Form S-3 for the shares of common stock issuable upon the conversion of the Series B convertible preferred stock issued in the private placement, plus certain shares of common stock sold to Technology Crossover Ventures in May 2000, declared effective within 180 days after the closing. We will be required to maintain the effectiveness of the registration statement until all of the common stock underlying the Series B convertible preferred stock issued in the private placement can be resold in any and all three month periods under Rule 144 under the Securities Act of 1933, without giving effect to Rule 144(k). We will be entitled to one blackout period not to exceed 90 days in any twelve-month period. Technology Crossover Ventures and Sutter Hill Ventures will also be granted piggyback registration rights to participate in underwritten offerings of our securities, subject to customary limitations.

Fees and Expenses

Whether or not the transactions contemplated in the share purchase agreement are consummated, we will pay the out-of-pocket costs and expenses of Technology Crossover Ventures and Sutter Hill Ventures arising in connection with the share purchase agreement.

Termination

The share purchase agreement may be terminated prior to the closing: (1) with mutual consent of eLoyalty and each of Technology Crossover Ventures and Sutter Hill Ventures; (2) by Technology Crossover Ventures and Sutter Hill Ventures, acting together, or us if the closing under the share purchase agreement is not completed by February 1, 2002 (unless due to a delay or default by the party(ies) seeking to terminate); (3) if specified transactions contemplated by the share purchase agreement, including the rights offering and sale of shares to the investors, is enjoined by a final, unappealable court order; and (4) if our stockholders fail to approve the proposals set forth in this proxy statement.

Use of Proceeds

As described above, the amount of proceeds we will receive from the sale of the Series B convertible preferred stock will depend on the purchase price of the Series B convertible preferred stock and extent to which stockholders exercise their rights to purchase shares of Series B convertible preferred stock pursuant to the rights offering. The total proceeds from the private placement will not exceed an aggregate of $25 million.

Table of Contents

We will pay from the net proceeds of the private placement and the rights offering the estimated placement and offering expenses of approximately $2.2 million and $1.0 million, respectively. We will use the net proceeds from the private placement and the rights offering for working capital and general corporate purposes.

Terms of the 7% Series B Convertible Preferred Stock

General

The following summarizes the material terms and provisions of the 7% Series B convertible preferred stock, and is qualified in its entirety by reference to the terms and provisions of our Certificate of Incorporation, as amended by a Certificate of Designation relating to the Series B convertible preferred stock, copies of which have been filed with the SEC and are incorporated by reference in this proxy statement.

When issued, the Series B convertible preferred stock will be validly issued, fully paid and non-assessable. The holders of the Series B convertible preferred stock will have no preemptive rights with respect to any shares of our capital stock or any other securities convertible into or carrying rights or options to purchase any of our capital stock. The Series B convertible preferred stock will not be subject to any obligation on our part to repurchase or retire the Series B convertible preferred stock except as described below under Rights Upon Liquidation.

Rank

The Series B convertible preferred stock will, with respect to dividend rights and rights on liquidation, rank senior to the common stock and to all other equity securities issued by us. For this purpose, the term equity securities does not include debt securities convertible into or exchangeable for equity securities.

Dividends

The holders of record of the Series B convertible preferred stock will be entitled to receive, when, as and if declared by our board of directors, out of funds legally available therefor, cash dividends on each share of Series B convertible preferred stock at an annual rate equal to 7% of the original purchase price per share of Series B convertible preferred stock, payable semi-annually. Additionally, except for dividends payable in common stock, holders of Series B convertible preferred stock shall be entitled to receive dividends paid on the common stock, if any, based on the number of shares of common stock into which such holder s shares of Series B convertible preferred stock would then convert, determined without reference to the limitation on conversion for the first six months after issuance. All dividends will be cumulative. Dividends will cease to accumulate in respect of shares of Series B convertible preferred stock on the date they are converted into shares of common stock.

Rights Upon Liquidation

In the event of any voluntary or involuntary liquidation, dissolution or winding up of the company, the holders of the Series B convertible preferred stock will be entitled to receive out of assets of the company available for distribution to stockholders, before any distribution of assets is made to holders of common stock or any other class of stock ranking junior to the Series B convertible preferred stock upon liquidation, liquidating distributions in the amount per share of Series B convertible preferred stock equal to the original price at which the stock was issued, plus accrued and unpaid dividends. After payment of the full amount of the liquidating distributions to which they are entitled, our remaining assets available for distribution shall be distributed pro rata among the holders of the common stock and Series B convertible preferred stock based on the number of shares of common stock into which the shares of Series B convertible preferred stock would then convert.

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

Table of Contents

transactions to which we are a direct contracting party in which in excess of 50% of our voting power is transferred (other than a merger or consolidation effected exclusively to change eLoyalty s domicile), or upon a sale or other transfer of all or substantially all of our assets (each, a Sale Transaction), the holders of the preferred stock will be entitled to the liquidating distribution described in the preceding paragraphs unless the holders of the common stock, assuming conversion of all of the Series B convertible preferred stock into common stock, would receive an amount equal to at least four times the original purchase price of the Series B convertible preferred stock, in which case the holders of the Series B convertible preferred stock will receive the amount that they would be entitled to if they had converted their stock into common stock immediately prior to the transaction.

Conversion

Each share of Series B convertible preferred stock is convertible into one share of our post-reverse stock split common stock, subject to adjustment as described below, at any time on or after six months after the closing of the private placement and the rights offering. In addition, the preferred stock will convert automatically into shares of common stock 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.

The conversion ratio initially is one share of Series B convertible preferred stock for one share of our post-reverse stock split common stock (see Proposal 3). The conversion ratio will be subject to adjustment if certain events occur, including: (1) the payment of dividends (and other distributions) in common stock on the outstanding shares of common stock or a subdivision of common stock into a greater number of shares of common stock, or (2) combinations and reclassifications of common stock, unless we take similar actions with respect to the Series B convertible preferred stock. If eLoyalty is party to any consolidation or merger in which it is not the surviving entity or transfers all or substantially all of its assets in a transaction that is not deemed to be a liquidation, then each share of Series B convertible preferred stock then outstanding would become convertible only into the kind and amount of securities, cash and other property that is receivable upon the occurrence of such event by a holder of the number of shares of common stock that the shares of Series B convertible preferred stock were convertible into immediately prior to the event, determined without regard to the limitation on conversion during the six months after issuance.

Voting Rights

Holders of the Series B convertible preferred stock will have the right to vote on all matters that the holders of common stock vote on, voting together with the holders of common stock as one class. Each share of Series B convertible preferred stock will be entitled to one vote for each share of common stock in which such share of Series B convertible preferred stock could then be converted, determined without regard to the limitation on conversion during the first six months after issuance.

The affirmative vote of the holders of a majority of the outstanding Series B convertible 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 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 by-laws in a way that adversely affects the rights, preferences or privileges of the Series B convertible preferred stock.

In addition, until six months after the closing of the private placement and the rights offering, the affirmative vote of the holders of at least 85% of the outstanding Series B convertible preferred stock present in

Table of Contents

person or by proxy and entitled to vote at a meeting held for this purpose shall be required prior to any Sale Transaction.

Restrictions on Transfer