MINDARROW SYSTEMS INC
Form 10-Q
August 13, 2002

Table of Contents

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549-1004

FORM 10-Q

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

For the quarterly period ended June 30, 2002

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

For the transition period from __________ to __________
Commission File Number: 0-28403

MindArrow Systems, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**77-0511097**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

2120 Main Street, Suite 200, Huntington Beach, California 92648
(Address of principal executive offices)

(714) 536-6200
(Registrant s telephone number, including area code)

101 Enterprise, Suite 340, Aliso Viejo, California 92656
(Former name, former address and formal fiscal year, if changed since last report)

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

The number of shares outstanding of each of the Registrant s classes of common stock:

28,421,878

(as of June 30, 2002)

TABLE OF CONTENTS

Consolidated Balance Sheets
Consolidated Statements of Operations
Consolidated Statement of Changes in Stockholders Equity
Consolidated Statements of Cash Flows
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Item 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK
PART II-OTHER INFORMATION
Item 1. Legal Proceedings
Item 2. Changes in Securities and Use of Proceeds
Item 3. Defaults Upon Senior Securities
Item 4. Submission of Matters to a Vote of Security Holders
Item 5. Other Information
Item 6. Exhibits and Reports on Form 8-K
SIGNATURES
EXHIBIT INDEX
EXHIBIT 2.1

Table of Contents

MindArrow Systems, Inc.

Quarterly Report on Form 10-Q

INDEX

		Page
	Part I. Financial Information	
Item 1.	**Consolidated Financial Statements:**	
	Consolidated Balance Sheets June 30, 2002 (unaudited) and September 30, 2001	**3**
	Consolidated Statements of Operations (unaudited) Three and Nine Months Ended June 30, 2002 and 2001	**4**
	Consolidated Statement of Changes in Stockholders Equity (unaudited) - Nine Months Ended June 30, 2002	**5**
	Consolidated Statements of Cash Flows (unaudited) Nine Months Ended June 30, 2002 and 2001	**6**
	Notes to Consolidated Financial Statements (unaudited)	**7**
Item 2.	**Management s Discussion and Analysis of Financial Condition and Results of Operations**	**13**
Item 3.	**Quantitative and Qualitative Disclosures about Market Risk**	**28**
	Part II. Other Information	
Item 1.	**Legal Proceedings**	**29**
Item 2.	**Changes in Securities and Use of Proceeds**	**29**
Item 3.	**Defaults Upon Senior Securities**	**30**
Item 4.	**Submission of Matters to a Vote of Security Holders**	**30**
Item 5.	**Other Information**	**30**
Item 6.	**Exhibits and Reports on Form 8-K**	**30**
Signatures		**32**

Table of Contents

MindArrow Systems, Inc. and Subsidiaries

Consolidated Balance Sheets

	June 30, 2002	September 30, 2001
	(unaudited)	
ASSETS		
Current Assets:		
Cash	$ 1,206,988	$ 1,345,376
Cash, pledged		178,650
Accounts receivable, net of allowance for doubtful accounts of $15,000 and $23,555 at June 30, 2002 and September 30, 2001, respectively	864,391	515,309
Prepaid expenses	184,834	128,230
Due from related parties	28,334	71,949
Other current assets	21,141	26,805
Total current assets	2,305,688	2,266,319
Fixed Assets, net	1,053,635	2,833,737
Intangible Assets, net	5,399,628	6,210,576
Deposits	174,158	144,580
Total assets	$ 8,933,109	$ 11,455,212
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable and accrued liabilities	$ 2,875,510	$ 2,443,333
Deferred revenue	767,704	1,075,221
Capital lease obligations	224,693	328,700
Notes payable, current portion	500,000	2,100,000
Due to related parties		187,208
Total current liabilities	4,367,907	6,134,462
Note payable, long term portion	500,000	1,000,000
Total liabilities	4,867,907	7,134,462
Stockholders Equity:		
Series B Convertible Preferred Stock, $0.001 par value; 1,750,000 shares authorized; 0 and 971,387 shares issued and outstanding as of June 30, 2002 and September 30, 2001; $0 and $7,771,096 aggregate liquidation preference as of June 30, 2002 and September 30, 2001`		971
Series C Convertible Preferred Stock, $0.001 par value; 3,000,000 shares authorized; 0 and 897,000 shares issued and outstanding as of June 30, 2002 and September 30, 2001; $0 and $22,425,000 aggregate liquidation preference as of June 30, 2002 and September 30, 2001`		897
Common Stock, $0.001 par value; 75,000,000 and 30,000,000 shares authorized as of June 30, 2002 and September 30, 2001; 28,421,878 and 13,695,682 shares issued and outstanding as of June 30, 2002 and September 30, 2001	28,422	13,696
Additional paid-in capital	77,550,358	73,166,417
Accumulated deficit	(73,513,578)	(68,861,231)

Total stockholders equity	4,065,202	4,320,750
Total liabilities and stockholders equity	$ 8,933,109	$ 11,455,212

The accompanying notes are an integral part of these statements.

Table of Contents

MindArrow Systems, Inc. and Subsidiaries

Consolidated Statements of Operations

	Three Months Ended		Nine Months Ended	
	June 30, 2002	June 30, 2001	June 30, 2002	June 30, 2001
	(unaudited)		(unaudited)	
Revenues	$ 1,236,345	$ 822,729	$ 3,082,482	$ 2,739,253
Operating expenses:				
Development	500,961	621,786	2,082,558	2,144,665
Production	370,374	431,082	1,358,977	1,301,044
Sales and marketing	673,104	1,205,964	2,327,443	4,969,565
General and administration	622,939	1,022,201	2,186,497	4,644,713
Loss on relocation	804,308		804,308	
Depreciation and amortization	753,963	698,005	2,523,594	2,031,804
	3,725,649	3,979,038	11,283,377	15,091,791
Operating loss	(2,489,304)	(3,156,309)	(8,200,895)	(12,352,538)
Interest income	575	31,054	4,911	222,149
Interest expense	(132,185)		(238,629)	
Other income (expense)	1,363	2,580	11,695	(64,157)
Recovery (loss) on transfer agent fraud	806,232	(169,957)	4,354,716	(19,609,090)
Net loss	(1,813,319)	(3,292,632)	(4,068,202)	(31,803,636)
Value of stock dividend on preferred stock	584,145		584,145	
Net loss available to common stockholders	$ (2,397,464)	$ (3,292,632)	$ (4,652,347)	$ (31,803,636)
Basic and diluted loss per share	$ (0.12)	$ (0.30)	$ (0.27)	$ (3.00)
Shares used in computation of basic and diluted loss per share	20,557,451	10,867,313	17,410,184	10,604,816

The accompanying notes are an integral part of these statements.

Table of Contents

MindArrow Systems, Inc. and Subsidiaries

Consolidated Statement of Changes in Stockholders Equity

	Series B Preferred Stock		Series C Preferred Stock		Common Stock	
	Shares	Amount	Shares	Amount	Shares	Amount
Balance, September 30, 2001	971,387	$ 971	897,000	$ 897	13,695,682	$13,696
Conversion of preferred stock to common stock	(971,387)	(971)	(897,000)	(897)	3,593,747	3,594
Return of contributed shares					960,571	960
Sale of common stock, net of issuance costs					6,900,000	6,900
Proceeds from notes payable attributable to warrants						
Issuance of warrants as liability settlement						
Compensation expense on warrant grants						
Issuance of common stock pursuant to exercise of options and warrants					2,040,000	2,040
Issuance of common stock and warrants for acquisition of minority interest in MindArrow Asia, Ltd.					150,000	150
Issuance of common stock as compensation for services					80,000	80
Issuance of common stock pursuant to bridge note					25,000	25
Cancellation of shares per indemnification clause of Control Commerce acquisition agreement					(47,937)	(48)
Stock dividend on preferred stock					1,024,815	1,025
Net loss						
Balance, June 30, 2002 (unaudited)		$		$	28,421,878	$28,422

[Additional columns below]

[Continued from above table, first column repeated]

	Additional Paid-In Capital	Accumulated Deficit	Total
Balance, September 30, 2001	$73,166,417	$(68,861,231)	$ 4,320,750
Conversion of preferred stock to common stock	(1,726)		
Return of contributed shares	(960)		
Sale of common stock, net of issuance costs	2,590,135		2,597,035
Proceeds from notes payable attributable to warrants	92,750		92,750
Issuance of warrants as liability settlement	52,800		52,800
Compensation expense on warrant grants	166,650		166,650
	753,960		756,000

Issuance of common stock pursuant to exercise of options and warrants			
Issuance of common stock and warrants for acquisition of minority interest in MindArrow Asia, Ltd.	149,850		150,000
Issuance of common stock as compensation for services	28,670		28,750
Issuance of common stock pursuant to bridge note	13,225		13,250
Cancellation of shares per indemnification clause of Control Commerce acquisition agreement	(44,533)		(44,581)
Stock dividend on preferred stock	583,120	(584,145)	
Net loss		(4,068,202)	(4,068,202)
Balance, June 30, 2002 (unaudited)	$77,550,358	$(73,513,578)	$ 4,065,202

The accompanying notes are an integral part of these statements.

Table of Contents

MindArrow Systems, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

	Nine Months Ended	
	June 30, 2002	**June 30, 2001**
	(unaudited)	
Cash flows from operating activities:		
Net loss	$ (4,068,202)	$ (31,803,636)
Adjustments to reconcile net loss to net cash used in operations:		
Depreciation and amortization	2,523,594	2,031,804
Loss on relocation	804,308	
Non-cash portion of recovery on transfer agent fraud	(15,000)	
Non-cash charges due to stock issuances	28,750	
Non-cash charges due to stock option and warrant grants	166,650	244,547
Amortization of discount on notes payable	136,000	
Non-cash charges due to contract settlements		1,191,701
Non-cash charge due to investment write-down		100,000
Non-cash charge for discrepant share adjustment		18,682,398
Non-cash charge for trade shows		49,145
Non-cash forgiveness of amount due from related party	28,333	28,333
Increase in accounts receivable	(349,082)	(42,445)
(Increase) decrease in prepaid expenses	(56,604)	222,786
(Increase) decrease in other current assets	(23,917)	584,288
Increase in deposits	(29,578)	(19,771)
Increase (decrease) in accounts payable and accrued liabilities	92,010	(365,351)
Increase (decrease) in deferred revenue	(307,517)	787,923
Net cash used in operations	(1,070,255)	(8,308,278)
Cash flows from investing activities:		
Decrease in cash-pledged	178,650	33,420
Purchases of fixed assets	(167,737)	(717,706)
Proceeds from sale of assets	1,800	21,051
(Increase) decrease in due from related parties	15,282	(17,722)
Net cash acquired in acquisition		938,536
Purchases of patents and trademarks	(27,948)	(76,046)
Net cash provided by investing activities	47	181,533
Cash flows from financing activities:		
Proceeds from issuance of common stock, net of issuance costs	2,597,035	183,334
Proceeds from notes payable, net of issuance costs	1,100,000	
Proceeds from option and warrant exercises	756,000	
Principal payments on notes payable	(3,230,000)	
Principal payments on capital lease obligations	(104,007)	
Decrease in due to related parties	(187,208)	(245,851)
Net cash provided by (used in) financing activities	931,820	(62,517)
Net decrease in cash	(138,388)	(8,189,262)
Cash, beginning of period	1,345,376	10,613,897
Cash, end of period	$ 1,206,988	$ 2,424,635

Cash paid for income taxes	$	$
Cash paid for interest	$ 13,938	$
Supplemental disclosure of noncash investing activities:		
In June 2001, the Company acquired Control Commerce, Inc. for 800,000 shares of common stock and 60,000 shares of Series C preferred stock	$	$ 1,536,400

The accompanying notes are an integral part of these statements.

Table of Contents

MindArrow Systems, Inc. and Subsidiaries

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note A The Company and Summary of Significant Accounting Policies

1. Basis of Presentation

The accompanying consolidated financial statements have been prepared by MindArrow Systems, Inc. and subsidiaries (the Company) pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC) for interim financial reporting. These consolidated financial statements are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring adjustments and accruals) necessary for a fair presentation of the balance sheets, operating results, and cash flows for the periods presented. Operating results for the three and nine months ended June 30, 2002 are not necessarily indicative of the results that may be expected for the fiscal year ending September 30, 2002. Certain financial information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been omitted in accordance with the rules and regulations of the SEC. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements, and accompanying notes, included in the Company s Annual Report on Form 10-K for the fiscal year ended September 30, 2001. The consolidated balance sheet at September 30, 2001 has been derived from the audited consolidated financial statements at that date.

2. Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany balances and transactions have been eliminated.

3. Basic and Diluted Net Loss Per Share

Basic net loss per share is computed using the weighted average number of common shares outstanding during the period. Diluted net loss per share is computed using the weighted average number of common shares during the period plus dilutive potential common shares. Dilutive potential common shares include the incremental common shares issuable upon the exercise of stock options and warrants (using the treasury stock method) and the incremental common shares issuable upon conversion of convertible preferred stock and notes payable (using the if-converted method). Potential common shares in the diluted net loss per share computation were excluded as their effect was antidilutive.

4. Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the amounts of revenues and expenses during the reported period. Actual results could differ from those estimates.

5. Concentration of Credit Risk

Financial instruments that potentially subject the Company to significant concentration of credit risk consist primarily of cash, cash equivalents, and accounts receivable. Substantially all of the Company s cash and cash equivalents are held in one financial institution. As of June 30, 2002 and September 30, 2001, the carrying amounts of cash were $1,206,988 and $1,524,026, respectively, and the bank balances were $1,210,026 and $1,764,047, respectively, of which $100,000 was FDIC insured. Accounts receivable are typically unsecured and derived primarily from customers located in the United States and Hong Kong. The Company performs ongoing credit evaluations of its customers and will maintain reserves for potential credit losses as the need arises.

Table of Contents

MindArrow Systems, Inc. and Subsidiaries
Notes to Consolidated Financial Statements (Continued)

6. Segments

The Company has adopted Statement of Financial Accounting Standards No. 131 Disclosures about Segments of an Enterprise and Related Information (SFAS 131). SFAS 131 establishes standards for reporting information regarding operating segments in annual financial statements and requires selected financial information for those segments to be presented in interim financial reports. SFAS 131 also establishes standards for related disclosures about products and services, and geographic areas. To date the Company has viewed their operations as principally one segment. The following is a summary of significant geographic markets:

	North America	Asia Pacific
For the nine months ended June 30, 2001:		
Net revenues	$1,966,413	$ 772,840
Long lived assets	3,704,417	1,469,021
For the nine months ended June 30, 2002:		
Net revenues	2,344,347	738,135
Long lived assets	5,684,906	768,357

Note B Liquidity

During the quarter ended June 30, 2002, the Company received $813,350 in proceeds from assets seized from the Company s former transfer agent and her accomplice (See Note C-2), received proceeds of $752,000 from the exercise of previously issued options and warrants to purchase 2,030,000 shares of common stock, and obtained a commitment for up to $4 million in additional financing (see Note E-2) of which $1.8 million, net of $500,000 in costs, were received by June 30, 2002. Another $700,000 is to be provided following approval of the terms of the transaction by the Company s shareholders, $540,000 is committed 45 days thereafter, and the final $1 million is committed if requested by the Company s board on thirty days notice, at any time between 60 days and nine months subsequent to closing or termination of the Category 5 merger (see Note G).

As of June 30, 2002, the Company had current assets of $2,305,688 and current liabilities of $4,367,907, respectively. This represents a working capital deficit of $2,062,219. The negative working capital balance includes as current liabilities approximately $800,000 of deferred revenues as well as a payment of $500,000 due October 1, 2002 on a promissory note issued in connection with the acquisition of substantially all of the assets of Radical Communication, Inc. in September 2001.

During the quarter ended June 30, 2002, the Company took further steps to reduce monthly cash operating expenses. Management currently estimates that cash operating expenses are approximately $600,000 per month. Over the past year revenues have averaged nearly $300,000 per month and during the quarter ended June 30, 2002, revenues increased to an average of $412,000 per month. Although the Company believes that as a result of an existing backlog of contracts and anticipated new contracts, monthly revenues will continue to increase over time, there can be no assurances that this will happen. Based on the current operating plan, available cash, and financing commitments currently in place, the Company may need to obtain additional financing prior to December 31, 2002. This need may also be eliminated with the resources available from the combined business of MindArrow and Category 5, should the proposed merger be consummated.

The accompanying consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, which contemplate continuation of the company as a going concern.

In the view of the Company, recoverability of a major portion of the recorded asset amounts shown in the accompanying balance sheet is dependent upon continued operations of the Company, which in turn is dependent upon the Company s ability to meet obligations on a continuing basis. The consolidated

Table of Contents

MindArrow Systems, Inc. and Subsidiaries
Notes to Consolidated Financial Statements (Continued)

financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or amounts and classification of liabilities that might be necessary should the Company be unable to continue in existence.

Note C Commitments and Contingencies

1. Legal Proceedings

From time to time the Company is subject to legal proceedings and claims in the ordinary course of business, including claims of alleged infringement of trademarks, copyrights and other intellectual property rights. The Company is not currently aware of any legal proceedings or claims that the Company believes will have, individually or in the aggregate, a material adverse effect on the Company s consolidated financial position or results of operations.

In May 2002, the Company moved its corporate offices from Aliso Viejo to Huntington Beach, California and is currently in default on the Aliso Viejo lease. The Company is in litigation with the landlord and has accordingly accrued for back rent and estimated settlement costs totaling approximately $521,000 included in Accounts payable and accrued liabilities on the accompanying consolidated balance sheet.

2. Transfer Agent Fraud

In October 2001, the Company received approximately $3.6 million in cash of assets seized from the Company s former transfer agent and her accomplice. Accordingly, the Company issued an aggregate of 764,381 shares of common stock to two shareholders who had previously contributed for cancellation by the Company 1,107,951 shares owned by them. In December 2001, the Company received two seized automobiles valued at $90,000 and issued an additional 18,779 shares of common stock to the contributing shareholders in March 2002. In May 2002, the Company received $798,350 in cash from the seized assets and accordingly issued an additional 177,411 shares to the contributing shareholders. In June 2002, the Company received one seized automobile valued at $15,000 and will issue an additional 3,177 shares to the contributing shareholders.

At sentencing hearings in April and July 2002, the perpetrators were ordered to pay to the Company $10.9 million in restitution in addition to amounts already received. Of that amount, $509,000 is due prior to December 31, 2002. In addition, the Company continues to pursue recovery of the loss it incurred as a result of the fraud perpetrated against the Company, and the Audit Committee of the Company s Board of Directors has retained special counsel to assist it in pursuing potential sources of recovery. Eight individuals and twelve entities have been named as defendants in lawsuits initiated by the Company. The Company cannot predict whether or when it will obtain any additional recovery. Because of the uncertainties surrounding recoveries, the Company will not record the impact of recoveries until amounts or assets are received. The recovery on transfer agent fraud of $4,354,716 on the accompanying consolidated statement of operations is net of approximately $127,000 of legal and other costs associated with pursuing recovery of assets.

Note D Notes Payable

In early December 2001, the Company received a $350,000 bridge loan. The bridge loan accrued interest at the rate of 10% per annum. As consideration for entering into the bridge loan the Company issued detachable warrants to purchase up to 50,000 shares of common stock at an exercise price of $1.15 per share. The warrants were valued at $12,000 as computed using the Black-Scholes option pricing model. The Company also paid a commitment fee of $17,500. The value of the warrants and the commitment fees paid have been included in interest expense on the accompanying consolidated statement of operations. The bridge loan was repaid in full in late December 2001.

In late March 2002, the Company received a $250,000 bridge loan. The bridge loan accrued interest at the rate of 24.9% per annum, was secured by any amounts recovered in connection with the transfer agent fraud (Note C), and matured on the earlier of May 28, 2002, or the release of those forfeiture

MindArrow Systems, Inc. and Subsidiaries
Notes to Consolidated Financial Statements (Continued)

proceeds. As consideration for entering into the bridge loan the Company issued detachable warrants to purchase up to 250,000 shares of common stock at an exercise price of $0.58 per share. The warrants were valued at $35,000 as computed using the Black-Scholes option pricing model. The Company also paid a commitment fee of $12,500 and issued 25,000 shares of common stock valued at $0.53 per share. For the quarter ended June 30, 2002, the Company included $57,712 in interest expense on the accompanying consolidated statement of operations as amortization of the total discount on the bridge note of $60,750. The bridge loan was repaid in full in May 2002.

In April 2002, the Company received additional bridge loans in the amount of $550,000. The bridge loans accrued interest at the rate of 15% per annum, and were secured by any amounts recovered in connection with the transfer agent fraud (Note C) and the Company s receivables and patents. The notes matured on the earlier of the release of forfeiture proceeds or various dates through July 10, 2002. As consideration for entering into the bridge loans the Company issued detachable warrants to purchase up to 275,000 shares of common stock at exercise prices from $0.64 to $0.74 per share. For the quarter ended June 30, 2002, the Company included $45,570 in interest expense on the accompanying consolidated statement of operations as amortization of the total discount on the bridge notes. The bridge loans were repaid in full in May 2002.

Note E Stockholders Equity

1. Preferred Stock Conversions

During the nine months ended June 30, 2002, 971,387 and 897,000 shares of Series B and Series C preferred stock, respectively, were converted into 1,236,016 and 2,357,731 shares of common stock, respectively, pursuant to the conversion rights of the Series B and Series C preferred stockholders and the agreement of all preferred shareholders to convert their shares upon the first closing of financing in June 2002 (see Note E-2). As an inducement for converting their preferred shares, and giving up their liquidation preference of approximately $27.7 million, the preferred shareholders received an additional 1,024,815 shares of common stock, valued at $532,904, and 1,024,815 warrants to purchase common stock at $1.00 per share, valued at $51,241, as computed using the Black-Scholes option pricing model. This amount is reflected as a stock dividend on the accompanying consolidated statement of operations. As of June 30, 2002, there were no remaining shares of Series B or Series C preferred stock.

2. Common Stock

In December 2001, the Company conducted a private placement of common stock and 2,500,000 shares of common stock were sold, raising gross proceeds of $1,500,000. The net proceeds from the offering, after repayment of the $350,000 bridge loan and payment of offering fees and expenses of approximately $202,000, was used by the Company for general working capital purposes. In connection with the private placement, the Company issued warrants to purchase 500,000 shares of common stock at an exercise price of $1.00 per share. The fair value of the warrants as computed using the Black-Scholes option pricing model was $95,000.

During the quarter ended March 31, 2002, 10,000 shares were issued upon option exercises. Total proceeds amounted to $4,000.

During the quarter ended March 31, 2002, the Company issued 150,000 shares of common stock and warrants to purchase 250,000 shares of common stock at $1.00 per share for the acquisition of the minority interest in MindArrow Asia, Ltd. The warrants expire September 30, 2004 and were estimated to have a fair value of $37,500 as computed using the Black-Scholes option pricing model.

During the quarter ended March 31, 2002, 80,000 shares were issued as compensation for services. The Company recognized compensation expense of $28,750.

During the quarter ended March 31, 2002, the Company cancelled 47,937 shares of common stock as reimbursement for legal costs incurred by the Company. These costs were indemnified per the terms of the Company s acquisition of Control Commerce, Inc.

Table of Contents

MindArrow Systems, Inc. and Subsidiaries
Notes to Consolidated Financial Statements (Continued)

During the quarter ended June 30, 2002, the board approved the reduction in the price of a previously-issued warrant for 2,000,000 shares from $2.00 per share to $0.37 per share, in exchange for the immediate exercise thereof. Net proceeds amounted to $740,000 in cash to the Company and recognition of compensation expense of $60,000. Additionally, 30,000 shares were issued upon option exercises resulting in total proceeds of $12,000.

In addition, in June 2002, the Company obtained a commitment for up to $4 million in financing by offering up to 10 million shares of common stock at a price of $0.40 per share. The Company received an initial $1.8 million in proceeds, net of approximately $500,000 in costs, and issued 4,400,000 shares during the quarter ended June 30, 2002. The stock purchase agreement, as amended in July 2002, calls for $700,000 to be provided following approval of the terms of the transaction by the Company s shareholders, $540,000 within 45 days thereafter, and the final $1 million if requested by the Company s board on thirty days notice, at any time between 60 days and nine months subsequent to closing or termination of the Category 5 merger (see Note G).

3. Warrants

During the nine months ended June 30, 2002, the Company issued to consultants warrants to purchase 2,056,000 shares of common stock. The warrants are exercisable at prices ranging from $0.75 per share to $2.00 per share, vest through March 2002 or upon meeting defined performance targets, and expire from November 2002 through November 2004.

The Company recognizes compensation expense based on the fair value of the warrants, as computed using the Black-Scholes option pricing model. The Company recognized compensation expense of $166,650 for the nine months ended June 30, 2002.

In connection with the additional financing commitments made during the quarter ended June 30, 2002, the Company issued warrants to purchase 7,100,000 shares of common stock. 1,100,000 of the warrants are exercisable at 60% of the average closing price of our stock if and when the Company s stock trades for 20 consecutive days below $0.40 per share, 2,400,000 are exercisable at $0.50 per share, 1,200,000 are exercisable at $0.75 if and when the Company s stock trades for 20 consecutive days above an average closing price of $1.50 per share, 1,200,000 are exercisable at $1.00 per share after June 12, 2003, and 1,200,000 are exercisable at $1.25 per share after December 12, 2003. The Company recognized financing costs of $853,000 during the quarter ended June 30, 2002 based on the fair value of the vested warrants as computed using the Black-Scholes option pricing model.

In November 2001, the Company issued warrants to purchase 80,000 shares of common stock at an exercise price of $0.10 per share as settlement of a liability. The fair value of the warrants as computed using the Black-Scholes option pricing model was $52,800.

4. Options

During the nine months ended June 30, 2002, the Company granted options to purchase 2,740,820 shares of common stock to employees, consultants and directors of the Company under the 1999 and 2000 Stock Option Plans at a weighted average exercise price of $0.68 per share. Under the 1999 and 2000 Stock Option Plans, 1,562,208 options expired during the nine months ended June 30, 2002, and 40,000 options were exercised.

Note F Due to Related Parties

During the quarter ended March 31, 2002, an executive officer, who is also a shareholder, loaned the Company $50,000. This amount was repaid in full during the quarter ended June 30, 2002.

Table of Contents

MindArrow Systems, Inc. and Subsidiaries
Notes to Consolidated Financial Statements (Continued)

Note G Subsequent Events

On July 12, 2002, the Company signed an agreement to merge with Category 5 Technologies Inc. (C5), a company that provides marketing tools and commerce-enabling technologies, primarily for small- to medium-sized businesses.

Under the proposed terms of the merger, each outstanding share of C5 will be exchanged for 2.3 shares of the Company s stock, such that the total number of shares to be issued to C5 stockholders will equal 55% of the total issued, outstanding shares of common stock of the Company (on a common equivalent basis) immediately after the merger.

C5 stockholders will also be granted additional warrants that would vest should C5 s ePenzio and Bring It Home businesses meet certain financial targets. If such warrants vest, C5 stockholders would own 60% of total issued, outstanding shares of common stock of the Company (on a common equivalent basis) immediately after the merger. Completion of the merger is subject to approval by the shareholders of each company and other customary closing conditions.

Table of Contents

Item 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read together with our consolidated financial statements and related notes included elsewhere in this quarterly report on Form 10-Q.

Overview

We were incorporated in April 1999 as eCommercial.com, and changed our name to MindArrow Systems, Inc. effective March 31, 2000. On April 24, 2000, we acquired majority control of Fusionactive, Ltd. which in December 2001 changed its name to MindArrow Asia Ltd., and we acquired the remaining minority interest in January 2002. On June 18, 2001, we acquired Control Commerce, Inc., a developer of e-commerce software. On September 12, 2001, we acquired substantially all of the assets of Radical Communication, Inc., a developer of rich media streaming video software.

Through June 30, 2002, our revenues were derived from the production and delivery of rich media messages as well as software license fees. Production services include theme development, design and layout, video production, special effects, hyperlink page design and creation, reporting and strategy consultation.

Revenues are recognized when the consulting or production services are rendered and messages are delivered. We recognize software license fee revenue when persuasive evidence of an agreement exists, the product has been delivered, we have no remaining significant obligations with regard to implementation, the license fee is fixed or determinable and collection of the fee is probable. MindArrow Asia s revenue from media sales is recognized upon placing advertisements. Revenue from consulting is recognized as the services are rendered.

We record cash receipts from clients and billed amounts due from clients in excess of revenue recognized as deferred revenue. The timing and amount of cash receipts from clients can vary significantly depending on specific contract terms and can therefore have a significant impact on the amount of deferred revenue in any given period.

We currently sell our products and services through a direct sales force and a small network of sales affiliates.

We may need additional financing

The capital requirements associated with developing our network and corporate infrastructure have been and will continue to be significant. We have been substantially dependent on private placements of our equity securities to fund such requirements.

At June 30, 2002, we had available cash of approximately $1.2 million and negative working capital of approximately $2.0 million. This negative working capital balance includes as current liabilities approximately $800,000 of deferred revenues as well as a payment of $500,000 due October 1, 2002 on a promissory note issued in connection with our acquisition of substantially all of the assets of Radical Communication, Inc. in September 2001. In addition, during the quarter ended June 30, 2002, we took further steps to reduce monthly cash operating expenses. We currently estimate that our cash operating expenses are approximately $600,000 per month. Over the past year our revenues have averaged nearly $300,000 per month and during the quarter ended June 30, 2002, revenues increased to an average of $412,000 per month. Although we believe that as a result of an existing backlog of contracts and anticipated new contracts, our monthly revenues will continue to increase over time, there can be no assurance that this will happen. Based on our current operating plan, available cash, and financing commitments currently in place, we estimate that we may need to obtain additional financing prior to December 31, 2002. This need may also be eliminated with the resources available from the combined business of MindArrow and Category 5 Technologies, should the proposed merger be consummated. In their report on our consolidated financial statements for the year ended September 30, 2001, our auditors expressed significant doubt about our ability to continue as a going concern. THERE CAN BE NO

Table of Contents

ASSURANCE THAT ANY ADDITIONAL FINANCING WILL BE AVAILABLE ON ACCEPTABLE TERMS, IF AT ALL. IF WE ARE UNSUCCESSFUL IN RAISING ADDITIONAL FUNDS, OUR LIQUIDITY POSITION WILL BE MATERIALLY AND ADVERSELY AFFECTED AND WE COULD BE REQUIRED TO MAKE DRASTIC COST REDUCTIONS, WHICH WOULD NEGATIVELY IMPACT OUR OPERATIONS.

Although we believe our assumptions underlying our operating plan to be reasonable, we lack the operating history of a more seasoned company and there can be no assurance that our forecasts will prove accurate. In the event that our plans change, our assumptions change or prove inaccurate, if the committed financing fell through, if the proposed merger does not close, or if future private placements, other capital resources and projected cash flow otherwise prove to be insufficient to fund operations, we could be required to seek additional financing sooner than currently anticipated. To the extent that we are able to raise additional funds and it involves the sale of our equity securities, the interests of our shareholders could be substantially diluted.

Results of operations

For the three and nine months ended June 30, 2002 and 2001, revenues totaled $1,236,345 and $3,082,482, respectively, compared to $822,729 and $2,739,253 for the corresponding periods in fiscal 2001. The increase of 50% and 13% from the same periods of the previous year was primarily due to recognition of revenue on a large custom software development engagement as well as other large engagements.

For the three and nine months ended June 30, 2002, our net loss available to common stockholders was $2,397,464, or $0.12 per share, and $4,652,347, or $0.27 per share, respectively, after giving effect to the value of the shares issued in exchange for the conversion of preferred stocks which has been treated as a stock dividend. For the three and nine months ended June 30, 2002, our net loss was $1,813,319, or $0.09 per share, and $4,068,202, or $0.23 per share, respectively, compared to $3,292,632, or $0.30 per share, and $31,803,636, or $3.00 per share for the corresponding periods in fiscal 2001. The decrease in loss of 45% and 87% from the same periods in the prior year can be attributed to the loss on transfer agent fraud recorded in fiscal 2001 in addition to recoveries on transfer agent fraud and cost cutting measures implemented in fiscal 2002.

For the quarter ended June 30, 2002, operating expenses of $3,725,649 included non-cash charges of: $753,963 for depreciation and amortization; $60,000 of stock-based compensation, and $28,333 for loan forgiveness. In addition, the following non-recurring amounts were also included: $804,308 in connection with relocating our offices and approximately $110,000 in facilities-related costs that will be eliminated in future quarters; $157,472 of personnel costs related to severance and reinstatement of back salaries; and approximately $45,000 of financing-related Nasdaq fees. This results in recurring cash-based expenses of $1,766,573 for the quarter, or approximately $589,000 per month.

In October 2001, we received approximately $3.6 million in cash that was seized from the Company s former transfer agent and her accomplice. Accordingly, we issued an aggregate of 764,381 shares of common stock to two of our shareholders who had previously contributed for cancellation by the Company 1,107,951 shares owned by them. In December 2001, we received two seized automobiles valued at $90,000 and issued an additional 18,779 shares of common stock to the contributing shareholders. In May 2002, we received an additional $798,350 in seized cash, and we issued 177,411 shares of common stock to the contributing shareholders. In June 2002, the Company received one seized automobile valued at $15,000 and will issue an additional 3,177 shares to the contributing shareholders. At sentencing hearings in April and July 2002, the perpetrators were ordered to pay to the Company $10.9 million in restitution in addition to amounts already received. Of that amount, $509,000 is due prior to December 31, 2002. We continue to pursue potential sources of recovery of the loss incurred as a result of the fraud and the Audit Committee of the Board of Directors has retained special counsel to assist it in pursuing potential sources of recovery and we have filed civil litigation seeking restitution and unspecified damages. We cannot predict whether or when we will obtain any additional recovery, including any recovery of the remaining seized assets held by the authorities. Because of the uncertainties surrounding recoveries, we

Table of Contents

will not record the impact of recoveries until amounts or assets are received. The recovery on transfer agent fraud of $4,354,716 on the accompanying consolidated statement of operations is net of approximately $127,000 of legal and other costs associated with pursuing recovery of assets for the nine months ended June 30, 2002.

Development expenses consist primarily of salaries and related expenses for software engineers and other technical personnel, including consultants, and were focused on continued advancements in multimedia communication technology and continued development of MindArrow Messenger and integrating technology acquired in the Control Commerce and Radical Communication acquisitions. Total development costs for the three and nine months ended June 30, 2002 amounted to $500,961 and $2,082,558, respectively, compared to $621,786 and $2,144,665 for the corresponding periods in fiscal 2001. We charge all research and development expenses to operations as incurred. We believe that continued investment in research and development is critical to our long-term success. During the quarter ended June 30, 2002, we completed certain development initiatives and subsequently reduced costs significantly. Accordingly, we expect research and development costs to decrease in terms of both absolute dollars and as a percentage of revenues.

Production efforts focused on building a team of creative design and client service personnel to produce rich media messages and help our clients implement our MindArrow Messenger and RadicalMail software suites. Total production costs for the three and nine months ended June 30, 2002 amounted to $370,374 and $1,358,977, respectively, compared to $431,082 and $1,301,044 for the corresponding periods in fiscal 2001.

Sales and marketing expenses for the three and nine months ended June 30, 2002 amounted to $673,104 and $2,327,443, respectively, compared to $1,205,964 and $4,969,565 for the corresponding periods in fiscal 2001. The expenses consisted primarily of salaries and related expenses for developing our direct and reseller organizations, as well as marketing expenses designed to create and promote brand awareness. The 44% and 53% decrease from the same periods in the prior year can be attributed to cost-cutting measures and shifting resources to relationship-based sales efforts from broader, branding-based marketing. To that end, we ve added several senior sales and marketing executives to our team that bring significant industry experience and relationships. We intend to leverage these relationships while aggressively managing our costs of selling.

General and administrative costs amounted to $622,939 and $2,186,497 for the three and nine months ended June 30, 2002, respectively, compared to $1,022,201 and $4,644,713 for the corresponding periods in fiscal 2001. The costs primarily included salaries and related expenses for administrative, finance and human resources personnel, professional fees and other costs of operating as a public company. The 39% and 53% decrease from the same periods in the prior year can be attributed to cost cutting measures. Included in the amount for the nine months ended June 30, 2001 is a one time charge of approximately $1.2 million related to the termination of one employment contract and two consulting contracts with former executive officers. Included in the amount for the quarter ended June 30, 2002, are non-cash charges of $60,000 of stock-based compensation and $28,333 for loan forgiveness. In addition, the following non-recurring amounts were also included: approximately $110,000 in facilities-related costs that will be eliminated in future quarters; $157,472 of personnel costs related to severance and reinstatement of back salaries; and approximately $45,000 of financing-related Nasdaq fees. During the quarter ended June 30, 2002, increased efficiencies in our processes permitted us to reduce future legal, facilities and administrative costs. Accordingly, we expect general and administrative costs to decrease accordingly.

In May 2002, the Company moved their corporate offices from Aliso Viejo, California to Huntington Beach, California. In connection with this move, the Company recorded losses of approximately $411,000 related to the disposal or write-down of leasehold improvements, furniture and equipment. Additionally, the Company is currently in default on the Aliso Viejo lease and in litigation with the landlord. Estimated settlement costs of approximately of $393,000 have been included in the quarter ended June 30, 2002.

Table of Contents

Recent financings

In June 2002, the Company obtained a commitment for up to $4 million in financing by offering up to 10 million shares of common stock at a price of $0.40 per share. The Company received an initial $1.8 million in proceeds, net of approximately $500,000 in costs, and issued 4,400,000 shares during the quarter ended June 30, 2002. The stock purchase agreement, as amended in July 2002, calls for $700,000 to be provided following approval of the terms of the transaction by the Company s shareholders, $540,000 within 45 days thereafter, and the final $1 million if requested by the Company s board on thirty days notice, at any time between 60 days and nine months subsequent to closing or termination of the Category 5 merger. The Company has also entered into advisory and consulting agreements with the investor to provide strategic consulting and other services, in return for the issuance of warrants to purchase up to 9 million shares of the Company s common stock, at prices ranging from $0.50 to $1.25. Should all warrants in connection with these transactions be exercised, the Company would receive an additional $7.5 million in cash.

In April 2002, the Company received bridge loans in the amount of $550,000 which were repaid in full in May 2002. The bridge loans accrued interest at the rate of 15% per annum, and were secured by any amounts recovered in connection with the transfer agent fraud, the Company s receivables and patents. The notes matured on the earlier of the release of forfeiture proceeds or various dates through July 10, 2002. As consideration for entering into the bridge loans the Company issued detachable warrants to purchase up to 275,000 shares of common stock at exercise prices from $0.64 to $0.74 per share.

In April 2002, our board approved the reduction in the price of a previously-issued warrant for 2,000,000 shares from $2.00 per share to $0.37 per share, in exchange for the immediate exercise thereof. Net proceeds amounted to $740,000 in cash to the Company.

In late March 2002, the Company received a $250,000 bridge loan which was repaid in full in May 2002. The bridge loan accrued interest at the rate of 24.9% per annum, was secured by any amounts recovered in connection with the transfer agent fraud, and matured on the earlier of May 28, 2002, or the release of those forfeiture proceeds. As consideration for entering into the bridge loan the Company issued detachable warrants to purchase up to 250,000 shares of common stock at an exercise price of $0.58 per share. The Company also paid a commitment fee of $12,500 and issued 25,000 shares of common stock at $0.53 per share.

In December 2001, we received a $350,000 bridge loan, accruing interest at 10% per annum that was repaid in full in December 2001. As consideration for entering into the bridge loan, we issued a warrant to purchase up to 50,000 shares of our common stock at an exercise price of $1.15 per share, and paid a placement fee of $17,500.

In December 2001, we conducted a private placement of our common stock to raise capital in which we sold a total of 2,500,000 shares of our common stock, raising gross proceeds of $1,500,000. The net proceeds from the offering, after repayment of the $350,000 bridge loan and payment of offering fees and expenses of approximately $202,000, was used by the Company for general working capital purposes. KSH Investment Group, Inc. acted as the placement agent for the private placement. As partial consideration for KSH s services, we issued to KSH warrants to purchase 500,000 shares of our common stock at an exercise price of $1.00 per share.

Liquidity and sources of capital

At June 30, 2002, we had available cash of approximately $1.2 million and negative working capital of approximately $2.0 million. This negative working capital balance includes as current liabilities approximately $800,000 of deferred revenues as well as a payment of $500,000 due October 1, 2002 on a promissory note issued in connection with our acquisition of substantially all of the assets of Radical Communication, Inc. in September 2001. In addition, during the quarter ended June 30, 2002, we took further steps to reduce monthly cash operating expenses. We currently estimate that our cash operating expenses are approximately $600,000 per month. Over the past year our revenues have averaged nearly $300,000 per month and during the quarter ended June 30, 2002, revenues increased to an average of

Table of Contents

$412,000 per month. Although we believe that as a result of an existing backlog of contracts and anticipated new contracts, our monthly revenues will continue to increase over time, there can be no assurance that this will happen. Based on our current operating plan, available cash, and financing commitments currently in place, we estimate that we may need to obtain additional financing prior to December 31, 2002. This need may also be eliminated with the resources available from the combined business of MindArrow and Category 5 Technologies, should the proposed merger be consummated.

As of June 30, 2002 and September 30, 2001, we had current assets of $2,305,688 and $2,266,319, respectively, and current liabilities of $4,367,907 and $6,134,462, respectively. This represents a working capital deficit of $2,062,219 and $3,868,143 at June 30, 2002 and September 30, 2001, respectively.

For the nine months ended June 30, 2002, $1,070,255 was used in operations compared to $8,308,278 for the nine months ended June 30, 2001. The 87% decrease in cash used in operations resulted from the recoveries from the transfer agent fraud and from reductions in costs in all areas. For the nine months ended June 30, 2002, $47 was provided by investing activities compared to $181,533 during the nine months ended June 30, 2001. During the nine months ended June 30, 2002, $931,820 was provided by financing activities compared to $62,517 used in financing activities during the nine months ended June 30, 2001.

Recent accounting pronouncements

On July 20, 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) 141, *Business Combinations,* and SFAS 142, *Goodwill and Other Intangible Assets*. SFAS 141 is effective for all business combinations completed after June 30, 2001. SFAS 142 is effective for fiscal years beginning after December 15, 2001; however, certain provisions of this Statement apply to goodwill and other intangible assets acquired between July 1, 2001 and the effective date of SFAS 142. Major provisions of these Statements and their effective dates for the Company are as follows:

All business combinations initiated after June 30, 2001 must use the purchase method of accounting. The pooling of interest method of accounting is prohibited except for transactions initiated before July 1, 2001.

Identifiable intangible assets acquired in a business combination must be recorded separately from goodwill if they arise from contractual or other legal rights or are separable from the acquired entity and can be sold, transferred, licensed, rented or exchanged, either individually or as part of a related contract, asset or liability.

Goodwill, as well as other intangible assets with indefinite lives, acquired after June 30, 2001, will not be amortized. Effective October 1, 2002, all previously recognized goodwill and other intangible assets with indefinite lives will no longer be subject to amortization.

Effective October 1, 2002, goodwill and other intangible assets with indefinite lives will be tested for impairment annually and whenever there is an impairment indicator.

All acquired goodwill must be assigned to reporting units for purposes of impairment testing and segment reporting.

The Company will continue to amortize goodwill and other intangible assets recognized prior to July 1, 2001, under its current method until October 1, 2002, at which time goodwill amortization will no longer be recognized. By September 30, 2003 the Company will have completed a transitional fair value based impairment test of goodwill as of October 1, 2002. By December 31, 2002, the Company will have completed a transitional impairment test of all other intangible assets with indefinite lives. Impairment losses, if any, resulting from the transitional testing will be recognized in the quarter ended December 31, 2002, as a cumulative effect of a change in accounting principle.

In August 2001, the Financial Accounting Standards Board issued SFAS 144, Accounting for the Impairment or Disposal of Long-lived Assets . This statement supersedes SFAS 121, Accounting for the

Table of Contents

Impairment of Long-lived Assets and for Long-lived Assets to be Disposed Of and Accounting Principles Board Opinion No. 30, Reporting Results of Operations Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions . This Statement retains the fundamental provisions of SFAS 121 for recognition and measurement of impairment, but amends the accounting and reporting standards for segments of a business to be disposed of. The provisions of this statement are required to be adopted no later than fiscal years beginning after December 31, 2001, with early adoption encouraged. The Company is currently evaluating the impact of the adoption of SFAS 144 but does not expect its impact to be material.

Table of Contents

Certain of the matters and subject areas discussed in this quarterly report on Form 10-Q contain forward-looking statements that are subject to a number of risks and uncertainties, many of which are beyond our control. All statements, other than statements of historical fact included in this report regarding our business strategy, future operations, financial position, estimated revenues, projected costs, prospects, plans and objectives of management as well as third parties are forward-looking statements. Generally, when used in this report, the words anticipate, intend, estimate, expect, project, and similar expressions are intended to identify forward-looking statements, although not all forward-looking statements contain such identifying words. All forward-looking statements speak only as of the date of this report. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we can give no assurance that such expectations will prove to be correct. Important factors that could cause our actual results to differ materially from our expectations are described below and in our other filings with the SEC.

Risk Factors

We may need additional financing

The capital requirements associated with developing our network and corporate infrastructure have been and will continue to be significant. We have been substantially dependent on private placements of our equity securities to fund such requirements.

At June 30, 2002, we had available cash of approximately $1.2 million and negative working capital of approximately $2.0 million. This negative working capital balance includes as current liabilities approximately $800,000 of deferred revenues as well as a payment of $500,000 due October 1, 2002 on a promissory note issued in connection with our acquisition of substantially all of the assets of Radical Communication, Inc. in September 2001. In addition, during the quarter ended June 30, 2002, we took further steps to reduce monthly cash operating expenses. We currently estimate that our cash operating expenses are approximately $600,000 per month. Over the past year our revenues have averaged nearly $300,000 per month and during the quarter ended June 30, 2002, revenues increased to an average of $412,000 per month. Although we believe that as a result of an existing backlog of contracts and anticipated new contracts, our monthly revenues will continue to increase over time, there can be no assurance that this will happen. Based on our current operating plan, available cash, and financing commitments currently in place, we estimate that we may need to obtain additional financing prior to December 31, 2002. This need may also be eliminated with the resources available from the combined business of MindArrow and Category 5 Technologies, should the proposed merger be consummated. In their report on our consolidated financial statements for the year ended September 30, 2001, our auditors expressed significant doubt about our ability to continue as a going concern. THERE CAN BE NO ASSURANCE THAT ANY ADDITIONAL FINANCING WILL BE AVAILABLE ON ACCEPTABLE TERMS, IF AT ALL. IF WE ARE UNSUCCESSFUL IN RAISING ADDITIONAL FUNDS, OUR LIQUIDITY POSITION WILL BE MATERIALLY AND ADVERSELY AFFECTED AND WE COULD BE REQUIRED TO MAKE DRASTIC COST REDUCTIONS, WHICH WOULD NEGATIVELY IMPACT OUR OPERATIONS.

Although we believe our assumptions underlying our operating plan to be reasonable, we lack the operating history of a more seasoned company and there can be no assurance that our forecasts will prove accurate. In the event that our plans change, our assumptions change or prove inaccurate, if the committed financing fell through, if the merger does not close, or if future private placements, other capital resources and projected cash flow otherwise prove to be insufficient to fund operations, we could be required to seek additional financing sooner than currently anticipated. To the extent that we are able to raise additional funds and it involves the sale of our equity securities, the interests of our shareholders could be substantially diluted.

Recent actions that we have taken may negatively impact our ability to achieve our business objectives

In order to manage our liquidity and cash position, over the past year we have had to implement certain cost cutting measures, including reductions in force of 68 employees. After these staff reductions,

Table of Contents

as of June 30, 2002, we had 51 full time employees worldwide. Although these cost cutting measures have improved our short-term cash requirements, they may negatively impact our ability to grow our business and achieve our business objectives.

We cannot assure you that our common stock will continue to be listed on the Nasdaq SmallCap Market

On February 14, 2002, MindArrow received notice from Nasdaq that MindArrow s common stock had closed below a required minimum bid price of $1.00 per share for a period of 30 consecutive trading days. In accordance with Nasdaq rules, MindArrow had 180 calendar days, or until August 13, 2002, to regain compliance with the minimum bid price requirement. In addition, Nasdaq may regard the proposed merger with Category 5 as a reverse merger , which would require under Nasdaq rules that the combined company qualify for initial inclusion on the Nasdaq SmallCap Market immediately following the merger. Although Nasdaq has not definitively informed MindArrow that the proposed merger would constitute a reverse merger , it is possible that Nasdaq could take this position prior to closing. We are seeking approval for the reverse stock split in order to assure that the combined company meets all of the requirements for initial inclusion on the Nasdaq SmallCap Market. However, there can be no assurance that, whether or not the merger and the reverse stock split are consummated, MindArrow s common stock would continue to trade on the Nasdaq SmallCap Market. If our common stock is delisted from the Nasdaq SmallCap Market, it will become significantly less liquid and may decline significantly in price.

Our limited operating history makes evaluation of our business difficult

Our business was formed as eCommercial.com in March 1999 and we were a development-stage company through December 31, 1999. In January 2000, principal operations commenced. We have recorded a cumulative net loss of approximately $57 million through June 30, 2002 (including $18.6 million attributable to the non-cash portion of the non-operating loss on transfer agent fraud) and anticipate recording losses in the near term. Accordingly, we have a limited operating history on which to base our evaluation of current business and prospects. Our short operating history makes it difficult to predict future results, and there are no assurances that our revenues will increase, or that we will achieve or maintain profitability or generate sufficient cash from operations in future periods.

Our ability to achieve and sustain profitability would be adversely affected if we:

- fail to effectively market and sell our services;
- fail to develop new and maintain existing relationships with clients;
- fail to continue to develop and upgrade our technology and network infrastructure;
- fail to respond to competitive developments;
- fail to introduce enhancements to our existing products and services to address new technologies and standards; or
- fail to attract and retain qualified personnel.

Our operating results are also dependent on factors outside of our control, such as strength of competition and the growth of the market for our services. There is no assurance that we will be successful in addressing these risks, and failure to do so could have a material adverse effect on our financial performance.

We expect to incur losses in the near term, and if we are unable to generate sufficient cash flow or raise the capital necessary to allow us to continue to meet all of our obligations as they come due, our business could suffer.

Our future revenues are not predictable, and our results could vary significantly

Because of our limited operating history and the emerging nature of our markets, we are unable to reliably forecast our revenues.

Our operating results may fluctuate significantly in the future as a result of a variety of factors. These factors include:

- the demand for our services;
- the addition or loss of individual clients;
- the amount and timing of capital expenditures and other costs relating to the expansion of our operations;
- the introduction of new products or services by us or our competitors; and
- general economic conditions and economic conditions specific to the Internet, such as electronic commerce and online media.

Any one of these factors could cause our revenues and operating results to vary significantly. In addition, as a strategic response to changes in the competitive environment, we may from time to time make certain pricing, service or marketing decisions or acquisitions that could significantly hurt our operating results in a given period.

Due to all of the foregoing factors, we believe that period-to-period comparisons of our results of operations are not necessarily meaningful and should not be relied upon as indications of future performance. Furthermore, it is possible that our operating results in one or more quarters will fail to meet the expectations of investors. In such event, the market price of our common stock could drop.

If we are unable to obtain funding, our customers and vendors may decide not to do business with us

If we are unable to continue funding our operations at our current levels, and if customers and vendors become concerned about our business prospects, they may decide not to conduct business with us, or may conduct business with us on terms that are less favorable than those customarily extended by them. In that event, our revenues would decrease and our business will suffer significantly.

We are not sure if the market will accept our product offerings

Our ability to succeed will depend on the following, none of which can be assured:

- the effectiveness of our marketing and sales efforts;
- market acceptance of our current and future offerings; and
- the reliability of our networks and services.

We operate in a market that is in the early stage of development, is rapidly evolving, and is characterized by an increasing number of competitors and risk surrounding market acceptance of new technologies and services. Potential customers must view our technologies as a viable alternative to traditional commercial advertising and brochure distribution. Because this market is so new, it is difficult to predict its size and growth rate. If the market fails to develop as we expect, our growth will be slower than expected.

We may make acquisitions of complementary technologies or businesses, which may disrupt our business and be dilutive to our existing stockholders.

We intend to consider acquisitions of businesses and technologies on an opportunistic basis, for example, our acquisitions of Control Commerce, Inc. and Radical Communication, Inc. Acquisitions of businesses and technologies involve numerous risks, including the diversion of management attention, difficulties in assimilating the acquired operations, loss of key employees from the acquired company, and difficulties in transitioning key customer relationships. In addition, these acquisitions may result in dilutive issuances of equity securities, the incurrence of additional debt, large one-time expenses and the creation of goodwill or other intangible assets that result in significant amortization expense and impairment charges. Any acquisition may not provide the benefits originally anticipated, and there may be difficulty in integrating the service offerings and customer and supplier relationships gained through acquisitions with our own. Although we attempt to minimize the risk of unexpected liabilities and contingencies associated with acquired businesses through planning, investigation and negotiation, such unexpected liabilities nevertheless may accompany such acquisitions. We cannot guarantee that we will successfully identify attractive acquisition candidates, complete and finance additional acquisitions on favorable terms, or integrate the acquired businesses or assets into our own. Any of these factors could materially harm our business or our operating results in a given period.

Network and system failures could adversely impact our business

The performance, reliability and availability of our Web sites and network infrastructure is critical to our reputation and ability to attract and retain clients. Our systems and operations are vulnerable to damage or interruption from earthquake, fire, flood, power loss, telecommunications failure, Internet breakdowns, break-ins, tornadoes and similar events. We carry business interruption insurance to compensate for losses that may occur, but insurance is not guaranteed to remove all risk of loss. Services based on sophisticated software and computer systems often encounter development delays and the underlying software may contain errors that could cause system failures. Any system failure that causes an interruption could result in a loss of clients and could reduce the attractiveness of our services.

We are also dependent upon Web browsers, Internet service providers and online service providers to provide Internet users access to our clients, users and Web sites. Users may experience difficulties due to system failures or delays unrelated to our systems. These difficulties may hurt audio and video quality or result in intermittent interruptions in broadcasting and thereby slow our growth.

Circumvention of our security measures and viruses could disrupt our business

Despite the implementation of security measures, our networks may be vulnerable to unauthorized access, computer viruses and other disruptive problems. Anyone who is able to circumvent security measures could steal proprietary information or cause interruptions in our operations. Service providers have occasionally experienced interruptions in service as a result of the accidental actions of users or intentional actions of hackers. We may have to spend significant capital to protect against security breaches or to fix problems caused by such breaches. Although we have implemented security measures, there can be no assurance that such measures will not be circumvented in the future. Eliminating computer viruses and alleviating other security problems may require interruptions, delays or cessation of service to users, which could hurt our business.

We depend on continued growth in use of the Internet

Rapid growth in use of the Internet is a recent phenomenon and there can be no assurance that use of the Internet will continue to grow or that a sufficient base of users will emerge to support our business. The Internet may not be accepted as a viable medium for broadcasting advertising and brochure distribution, for a number of reasons, including:

- inadequate development of the necessary infrastructure;
- inadequate development of enabling technologies;
- lack of acceptance of the Internet as a medium for distributing rich media advertising; and
- inadequate commercial support for Web-based advertising.

To the extent that Internet use continues to increase, there can be no assurance that the Internet infrastructure will be able to support the demands placed upon it, and especially the demands of delivering high-quality video content.

Furthermore, user experiences on the Internet are affected by access speed. There is no assurance that broadband access technologies will become widely adopted. In addition, the Internet could lose its viability as a commercial medium due to delays in the development or adoption of new standards and protocols required to handle increased levels of Internet activity, or due to increased government regulation. Our business could suffer if use of the Internet grows more slowly than expected, or if the Internet infrastructure does not effectively support the growth that does occur.

Table of Contents

If we do not respond to technological change, we could lose or fail to develop customers

The development of our business entails significant technical and business risks. To remain competitive, we must continue to enhance and improve the functionality and features of our technology. The Internet and the ecommerce industry are characterized by:

- rapid technological change;
- changes in client requirements and preferences;
- frequent new product and service introductions embodying new technologies; and
- the emergence of new industry standards and practices.

The evolving nature of the Internet could render our existing systems obsolete.

Our success will depend, in part, on our ability to:

- develop and enhance technologies useful in our business;
- develop new services and technology that address the increasingly sophisticated and varied needs of our current and prospective clients; and
- adapt to technological advances and emerging industry and regulatory standards and practices in a cost-effective and timely manner.

Future advances in technology may not be beneficial to, or compatible with, our business. Furthermore, we may not use new technologies effectively or adapt our systems to client requirements or emerging industry standards on a timely basis. Our ability to remain technologically competitive may require substantial expenditures and lead time. If we are unable to adapt to changing market conditions or user requirements in a timely manner, we will lose clients.

We could face liability for Internet content

As a distributor of Internet content, we face potential liability for negligence, copyright, patent or trademark infringement, defamation, indecency and other claims based on the content of our broadcasts. Such claims have been brought, and sometimes successfully pressed, against Internet content distributors. Our general liability insurance may not be adequate to indemnify us for all liability that may be imposed. Although we generally require our clients to indemnify us for such liability, such indemnification may be inadequate. Any imposition of liability that is not covered by insurance or by an indemnification by a client could harm our business.

Our operating results could be impaired if we become subject to burdensome government regulations and legal uncertainties concerning the Internet

Due to the increasing popularity and use of the Internet, it is possible that a number of laws and regulations may be adopted with respect to the Internet, relating to:

- user privacy;
- pricing, usage fees and taxes;
- content;
- copyrights;
- distribution;
- characteristics and quality of products and services; and
- online advertising and marketing.

The adoption of any additional laws or regulations may decrease the popularity or impede the expansion of the Internet and could seriously harm our business. A decline in the popularity or growth of the Internet could decrease demand for our products and services, reduce our revenues and margins

Table of Contents

and increase our cost of doing business. Moreover, the applicability of existing laws to the Internet is uncertain with regard to many important issues, including property ownership, intellectual property, export of encryption technology, libel and personal privacy. The application of laws and regulations from jurisdictions whose laws do not currently apply to our business, or the application of existing laws and regulations to the Internet and other online services, could also harm our business.

Our stock price has been and may continue to be volatile

The trading price of our common stock has been and is likely to continue to be highly volatile. For example, on May 9, 2001, our common stock closed at $2.00 per share, and on April 18, 2002, our common stock closed at $0.37 per share. On July 31, 2002, our common stock closed at $0.42 per share. Our stock price could be subject to wide fluctuations in response to factors such as:

- the average daily trading volume of our common stock;
- actual or anticipated variations in quarterly operating results and our need for additional financing to fund our continuing operations;
- announcements of technological innovations, new products or services by us or our competitors;
- the addition or loss of strategic relationships or relationships with our key customers;
- conditions or trends in the Internet, streaming media, media delivery, and online commerce markets;
- changes in the market valuations of other Internet, online service, or software companies;
- announcements by us or our competitors of significant acquisitions, strategic partnerships, joint ventures, or capital commitments;
- sales of our common stock and legal or regulatory developments;
- additions or departures of key personnel;
- our failure to obtain additional financing on satisfactory terms, or at all; and
- general market conditions.

The historical volatility of our stock price may make it more difficult for investors in our securities to resell shares at prices they find attractive. See also Risk Factors We cannot assure you that our common stock will continue to be listed on the Nasdaq SmallCap Market.

In addition, the stock market in general, the Nasdaq SmallCap Market, the market for Internet and technology companies in particular, have experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of these companies. These broad market and industry factors may reduce our stock price, regardless of our operating performance.

Future sales of our common stock may depress our stock price

Sales of a substantial number of shares of our common stock in the public market, or the appearance that such shares are available for sale, could adversely affect the market price for our common stock. As of June 30, 2002, we had 28,421,878 shares of common stock outstanding. A significant number of these shares are not publicly traded but are available for immediate resale to the public. We also have reserved shares of our common stock as follows:

- 12,629,305 shares are reserved for issuance upon the exercise of warrants;
- 2,475,000 shares are reserved for issuance under our 1999 Stock Option Plan; and
- 1,997,500 shares are reserved for issuance under our 2000 Stock Option Plan.

Shares underlying vested options are generally eligible for immediate resale in the public market.

Table of Contents

Our efforts to protect our intellectual property rights may not sufficiently protect us and we may incur costly litigation to protect our rights

We have filed nineteen patent applications and we plan to file additional patent applications in the future with respect to various additional aspects of our technologies. In addition, we have received one patent on technology we obtained in the Control Commerce acquisition. We mark our software with copyright notices, and intend to file copyright registration applications where appropriate. We have also filed several federal trademark registration applications for trademarks and service marks we use. There can, however, be no assurance that any patents, copyright registrations, or trademark registrations applied for by us will be issued, or if issued, will sufficiently protect our proprietary rights.

We also rely substantially on certain technologies that are not patentable or proprietary and are therefore available to our competitors. In addition, many of the processes and much of our technology are dependent upon our technical personnel, whose skill, knowledge and experience are not patentable. To protect our rights in these areas, we require all employees, significant consultants and advisors to enter into confidentiality agreements under which they agree not to use or disclose our confidential information as long as that information remains proprietary. We also require that our employees agree to assign to us all rights to any inventions made during their employment relating to our activities, and not engage in activities similar to ours during the term of their employment. There can be no assurance, however, that these agreements will provide meaningful protection for our trade secrets, know-how or other proprietary information in the event of any unauthorized use or disclosure of such trade secrets, know-how or proprietary information. Further, in the absence of patent protection, we may be exposed to competitors who independently develop substantially equivalent technology or otherwise gain access to our trade secrets, knowledge or other proprietary information.

Despite our efforts to protect our intellectual property, a third party or a former employee could copy, reverse-engineer or otherwise obtain and use our intellectual property or trade secrets without authorization or could develop technology competitive to ours.

Our intellectual property may be misappropriated or infringed upon. Consequently, litigation may be necessary in the future to enforce our intellectual property rights, to protect our confidential information or trade secrets, or to determine the validity or scope of the rights of others. Litigation could result in substantial costs and diversion of management and other resources and may not successfully protect our intellectual property. Additionally, we may deem it advisable to enter into royalty or licensing agreements to resolve such claims. Such agreements, if required, may not be available on commercially reasonable or desirable terms or at all.

Our technology may infringe on the rights of others

Even if the patents, copyrights and trademarks we apply for are granted, they do not confer on us the right to manufacture or market products or services if such products or services infringe on intellectual property rights held by others. If any third parties hold conflicting rights, we may be required to stop making, using, or marketing one or more of our products or to obtain licenses from and pay royalties to others, which could have a significant and material adverse effect on us. There can be no assurance that we will be able to obtain or maintain any such license on acceptable terms or at all.

We may also be subject to litigation to defend against claims of infringement of the rights of others or to determine the scope and validity of the intellectual property rights of others. If third parties hold trademark, copyright or patent rights that conflict with our business, then we may be forced to litigate infringement claims that could result in substantial costs to us. In addition, if we were unsuccessful in defending such a claim, it could have a negative financial impact. If third parties prepare and file applications in the United States that claim trademarks used or registered by us, we may oppose those applications and be required to participate in proceedings before the United States Patent and Trademark Office to determine priority of rights to the trademark, which could result in substantial costs to us. An adverse outcome in litigation or privity proceedings could require us to license disputed rights from third parties or to cease using such rights. Any litigation regarding our proprietary rights could be costly, divert management s attention, result in the loss of certain of our proprietary rights, require us to seek licenses from third parties and prevent us from selling our services, any one of which could have a negative financial impact. In addition, inasmuch as we broadcast content developed by third parties, our exposure to copyright infringement actions may increase because we must rely upon such third parties for information as to the origin and ownership of such licensed content. We generally obtain representations as to the origin and ownership of such licensed content and generally obtain indemnification to cover any breach of such representations; however, there can be no assurance that such representations will be accurate or given, or that such indemnification will adequately protect us.

The length of our sales cycle increases our costs

Many of our potential customers conduct extensive and lengthy evaluations before deciding whether to purchase or license our products. In our experience to date we ve seen the sales cycle range from a few days up to six months. While the potential customer is making this decision, we continue to incur salary, travel and other similar costs of following up with these accounts. Therefore, the risk associated with our lengthy sales cycle is that we may expend substantial time and resources over the course of the sales cycle only to realize no revenue from such efforts if the customer decides not to purchase from us. Any significant change in customer buying decisions or sales cycles for our products could have a material adverse effect on our business, results of operations, and financial conditions.

We have a limited operating history in international markets

We have only limited experience in operating in international markets. Although we have distributed our products and services internationally since August 1999, we had no experience in international operations prior to the acquisition of our Hong Kong-based subsidiary, MindArrow Asia Ltd., in April 2000. Through June 2002, we have recognized approximately $2.0 million of revenue related to our international operations in eastern Asia. There can be no assurance that our international operations will be successful.

There are risks inherent in conducting international operations

There are many risks associated with our international operations in eastern Asia, including, but not limited to:

difficulties in collecting accounts receivable and longer collection periods;

changing and conflicting regulatory requirements;

potentially adverse tax consequences;

tariffs and gener