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convertible debentures (including $18,122 and 38,356, respectively, in accrued interest) into 107,981 and 307,509 shares of the Company's common stock at $2.02 and $1.43 per share pursuant to the original debenture terms. The Company issued 200,000 shares of its common stock at $0.25 per share pursuant to a warrant exercise for gross proceeds of $50,000. The Company completed a private placement offering of 280,000 shares of its common stock at $2.50 per share for gross proceeds of $700,000. The Company completed a private placement offering of 828,496 shares of its common stock at $2.00 per share for gross proceeds of $1,656,980. The Company is actively pursuing various financing opportunities. Such financing could take the form of equity, debt, or other hybrid types of securities. NOTE E - DEBT In March 2001, the Company issued $790,369 in subordinated debentures that are convertible immediately into common stock. The debentures bear simple interest at 8% per annum, are due May 31, 2001 and are collateralized by UltraCard's interest in the equipment held for sale. In March 2001, the Company issued 16,267 and 18,429 shares of its common stock at $3.75 and $3.31 per share as additional financing fees under the terms of a modified promissory note. In addition, under the terms of the aforementioned note, the Company granted warrants entitling the holder to purchase 20,277, 40,664 and 23,034 shares of its common stock at $3.75, $6.00 and $3.31 per share, respectively. The warrants are exercisable immediately and expire 90 days from the date of grant. In March 2001, the Company obtained a 12.5% simple interest mortgage loan totaling $400,000. The loan calls for interest only monthly payments with the first payment due May 1, 2001 and principal plus unpaid interest due February 2002. The loan is collateralized by the condominiums owned by UltraCard. NOTE F - ACQUISITIONS On September 8, 2000 the Company signed an Agreement and Plan of Reorganization ("Agreement") to acquire 100% of The Pathways Group, Inc. (Pathways) On February 15, 2001 the Company delivered notice to Pathways terminating the merger agreement between the two Companies. The advances to Pathways by the Company are secured by a blanket assignment over the Pathways assets. Management believes the advances are fully recoverable. On December 11, 2000 the Company entered into a letter of intent to acquire majority interest totaling 57 percent in Rockster, Inc. (Rockster), an entertainment distribution technology developer. The Company and Rockster are currently in the process of developing a definitive agreement. On January 16, 2001, the Company discontinued negotiations with Cards & More GMBH, for the acquisition of 60% of that Company announced in September 2000. NOTE G - COMMITMENTS The Company has a contract with SciVac, Inc. (SciVac) to purchase and install a sputtering machine for $3,000,000. As of March 31, 2001, the Company has advanced $1,200,000 to SciVac under this contract and recorded a liability of $1,800,000. The Company decided that it no longer requires the machine for its operations. As a result, the Company has entered into an oral agreement with SciVac, whereas, SciVac will market and sell the sputtering machine on behalf of the Company. This asset is classified in the accompanying condensed consolidated balance sheet as equipment held for sale in the amount of $3,054,125. The Company believes it will realize the carrying amount of the asset in a sale during 2001. On March 13, 2001, the Company entered into an operating lease agreement to lease a 28,500 square foot facility in Los Angeles, California. The agreement calls for monthly payment of $43,200 commencing August 1, 2001. The lease terminates August 1, 2011. On October 10, 1997, UltraCard licensed the rights to two technology patents from CardTech, Inc. (CardTech). UltraCard's President is also the controlling stockholder of CardTech. UltraCard is required to pay CardTech a minimum annual royalty fee of $650,000. Royalty fees are due on January 1 of each calendar year. As of March 31, 2001, $1,300,000 for both the calendar year 2000 and 2001 royalty fees remained unpaid, causing UltraCard to be past due on the agreement. CardTech has deferred the required 2000 and 2001 payments to June 30, 2001. In consideration for the deferral, UltraCard has granted a patent mortgage to CardTech on all its intellectual property. NOTE H - CONTINGENCIES The class action lawsuits filed during February and March 2000, in the United States District Court, against the Company and its President alleging securities violations were dismissed, with prejudice by the United States District Court. Plaintiffs appealed the Court's order, and the defendants filed a cross appeal seeking sanctions. The parties have since entered into a stipulated agreement to dismiss their appeals. NOTE I - SUBSEQUENT EVENTS During April, 2001, the Company issued common stock at $2 per share for a total of $1,030,000. The offer and sales of securities was made pursuant to an exemption from registration under Regulation S of the Securities Act of 1933 (Act), due to the foreign nationality of the investors. During May, 2001 to the date of this report, the Company issued common stock at $2 per share for a total of $196,000. The offer and sales of securities was made pursuant to an exemption from registration under Regulation S of the Act, due to the foreign nationality of the investors. ITEM 2. MANAGEMENT DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS Certain statements contained in this Quarterly Report on Form 10-QSB, including, without limitation, statements containing the words "believes, " anticipates," "estimates," "expects," and words of similar import, constitute "forward looking statements." You should not place undue reliance on these forward- looking statements. Our actual results could differ materially from those anticipated in these forward- looking statements for many reasons, including the risks faced by us described in this Quarterly Report and in other documents we file with the Securities and Exchange Commission. Net losses aggregated $12.9 million in the first six months of the current fiscal year ending September 30, 2001 compared with a $6.3 million net loss for the corresponding period of the prior fiscal year. This increase in net loss reflects a continued and growing level of investment into the Company's technology, production processes and the development of commercialization of the Companies core technology through the acquisition of application companies. During the quarter, the Company's subsidiary, UltraCard Inc. has completed their move into new facilities in Los Gatos completing the consolidation of the operations into one location. Significant administrative costs have been incurred in reorganizing the Company's acquisitions of application companies and in their capital raising initiatives. UltraCard Inc., has again increased its research and development expenditures by $2.1 million over the corresponding prior period in a concentrated effort to complete a commercialized version of its high memory capacity UltraCard and read write device. These increasing expenditures reflect the Company's focused efforts upon completing its research and development initiatives, while at the same time, establishing production processes and specifications to facilitate the Company to engage others to produce the UltraCard and its read write device. The other significant operating subsidiary cQue (formerly Centurion) contributed only 3% of the total loss reflecting the focus of the consolidated groups efforts to complete the UltraCard technology. During the six month period, EforNet discontinued their research and development program in light of acquisitions being developed during the period, however the developments that they had achieved are being maintained and protected and will be further developed within the Company's developing infrastructure. A significant portion of the increase in research and development expenditures was due to the addition of new personnel, prototype development and contracts with external research and development contractors. For the near future, research and development expenditures are expected to be increased to meet the Company's numerous potential market opportunities. All of the Company's research and development costs are expensed as incurred. The net loss for the three month period ended March 31, 2001 of $7.8 million represents a $4.4 million increase over the corresponding period in the prior year. A significant portion of this increased loss ($2.98 million) is comprised of non-cash financing costs associated with warrants issued for services, the extension of warrants previously issued, debenture discounts and common shares issued for financing fees. The additional increase is comprised of a step up in sales and marketing expenditures of $240,000 reflecting the Company's increasing efforts to raise market awareness of its products and potential. The balance of the increase is allocated to general and administrative expenditures incurred by the growing group of companies. Interest expense has also increased significantly as the result of the valuation of shares and warrants issued in relation to unpaid notes and debentures issued during the period. In an effort to accelerate the Company's market penetration with the UltraCard and related products, and in order to augment internally developed research and development initiatives, the Company will license technology from other businesses, engage others to develop components and/or acquire other businesses as an alternative to internal research and development and marketing efforts. The marketplace is beginning to recognize the UltraCard as a leader and superior product in the smart card industry and management are focused upon accelerating the Companies access to this multi-billion dollar marketplace. Sales and marketing expenditures have decreased by approximately $0.3 million from the prior quarter as the prior quarter costs included a technology symposium in San Francisco, in which the Companies in the consolidated Group showcased their products to investors, industry and the media. Sales and marketing expenditures are associated with the Company's attendance at trade shows and industry awareness programs as the Company builds market awareness to establish and develop new markets and prepare for effective product launches for products which are currently under development. LIQUIDITY AND CAPITAL RESOURCES Cash and equivalents were approximately $400,000 at March 31, 2001, an increase of approximately $500,000 from December 31, 2000. The Company is managing tight cash flows in providing funding for an aggressive research and development program at UltraCard while developing acquisitions in the software development area of business. Cash flows from financing activities of $9.4 million in the current six month period represents a 38% increase in the capital raised in the corresponding period of the preceding year. The proceeds were used for operations of $6.7 million, with the balance of $2.5 million allocated to investing activities for acquisitions in process of Pathways and Rockster and the development of the UltraCard facilities. The Company is successfully raising capital on an ongoing basis as it has done for the last three years since inception. In order for the Company to meet the funding requirements from its investee Companies and to meet ongoing operating requirements, the Company will have to raise additional financing. The Company expects that its existing and planned capital resources will be adequate to satisfy the requirements of the current and planned operations until the end of the current fiscal year. However the rate at which the Company expends its resources is variable, may be accelerated, and will depend on many factors. The Company will need to raise substantial additional capital to fund its operations and may seek such additional funding through public or private equity or debt financing, or through the licensing of its technology. There can be no assurance that such additional funding will be available on acceptable terms, if at all. PART II Other Information Item 1. Legal Proceedings ------- In Re Upgrade International Corporation Securities Litigation, U.S. District Court, Western District of Washington at Seattle, c/a #C00-0298, the class action against Upgrade and its president, Daniel S. Bland, was dismissed by court dated February 9, 2001. Plaintiffs appealed the court's order, and the defendants filed a cross appeal seeking sanctions. The parties have since entered into a stipulated agreement to dismiss their appeals. Lewis v. The Pathways Group, Inc. and Upgrade International Corporation, U.S. -- District Court, Western District of Washington at Seattle, c/a #C01-0600R. The complaint alleges copyright infringement, misappropriation of trade secrets, and tortuous interference with business expectancies against Upgrade by virtue of the proposed merger between Upgrade and The Pathways Group, which merger proposal was terminated by Upgrade on February 15, 2001. The complaint seeks injunctive relief and unspecified damages. The Company filed an answer on May 17, 2001. Management believes the case is without merit and intends to defend it vigorously. Item 2. Changes in Securities and Use of Proceeds -------- During the three months ended March 31, 2001, the Company sold unregistered securities as follows: In January 2001, Upgrade issued 107,981 shares of its common stock at a price of $2.02 per share pursuant to the conversion of debentures. As reported in the Company's Form 10-QSB for the period ended December 31, 2000, the issuance was exempt under Rule 506 under and Section 4(2) of the Securities Act of 1933 (the "Act"). In January 2001, Upgrade issued 200,000 shares of its common stock at a price of $0.25 per share pursuant to the exercise of warrants. The issuance was exempt from registration pursuant to Regulation S of the Securities Act of 1933, due to the foreign nationality of the investor. In January 2001, Upgrade completed a private placement offering of 200,000 shares of its common stock at a price of $2.50 per share for total proceeds of $500,000. The offer and sale of securities was made pursuant to an exemption from registration under Regulation S of the Act, due to the foreign nationality of the investor. In January 2001, Upgrade completed a private placement offering of 265,000 shares of its common stock at a price of $2.00 per share for total proceeds of $530,000. The offer and sale of securities was made pursuant to an exemption from registration under Regulation S of the Securities Act of 1933, due to the foreign nationality of the investor. In February 2001, Upgrade issued 307,509 shares of its common stock at a price of $1.43 per share pursuant to the conversion of debentures. As reported in the Company's Form 10-QSB for the period ended December 31, 2000, the issuance was exempt under Rule 506 under and Section 4(2) of the Act. In February 2001, Upgrade completed a private placement offering of 358,496 shares of its common stock at a price of $2.00 per share for total proceeds of $716,980. The offer and sale of securities was made pursuant to an exemption from registration under Regulation S of the Securities Act of 1933, due to the foreign nationality of the investor. In February 2001, Upgrade completed a private placement offering of 80,000 shares of its common stock at a price of $2.50 per share for total proceeds of $200,000. The offer and sale was exempt under Rule 506 under and Section 4(2) of the Act. In March 2001, Upgrade completed a private placement offering of 205,000 shares of its common stock at a price of $2.00 per share for total proceeds of $410,000. The offer and sale was exempt under Rule 506 under and Section 4(2) of the Act. In March 2001, Upgrade issued 16,267 shares of its common stock at a price of $3.75 per share in lieu of financing fees under the terms of a promissory note. The issuance was exempt under Rule 506 under and Section 4(2) of the Act. In March 2001, Upgrade issued 18,429 shares of its common stock at a price of $3.31 per share in lieu of financing fees under the terms of a promissory note. The issuance was exempt under Rule 506 under and Section 4(2) of the Act. In March 2001, Upgrade issued warrants to purchase 20,277 shares of its common stock at an exercise price of $3.75 per share in lieu of financing fees under the terms of a promissory note. The issuance was exempt under Rule 506 under and Section 4(2) of the Act. In March 2001, Upgrade issued warrants to purchase 40,664 shares of its common stock at an exercise price of $6.00 per share in lieu of financing fees under the terms of a promissory note.

The issuance was exempt under Rule 506 under and Section 4(2) of the Act. In March 2001, Upgrade issued warrants to purchase 23,034 shares of its common stock at an exercise price of $3.31 per share as additional compensation under the terms of a promissory note. The issuance was exempt under Rule 506 under and Section 4(2) of the Act. Item 4. Submission of Matters to a Vote of Security Holders ------- On March 27, 2001, the Company held its Annual Meeting of Shareholders. The shareholders voted on and approved the following matters, with the voting results indicated: Election of Directors: Daniel S. Bland, Class 3 (term expiring 2004) For: 11,273,980 Withheld Vote: 123,068 Malcolm P. Burke, Class 3 (term expiring 2004) For: 11,277,580 Withheld Vote: 119,468 Ronald P. Erickson, Class 2 (term expiring 2003) For: 11,132,474 Withheld Vote: 264,574 Howard A. Jaffe, Class 2 (term expiring 2003) For: 11,271,930 Withheld Vote: 125,118 For approval of the Company's 2000 Omnibus Stock Option Plan For Against Abstain Broker Non-Votes --- ------- ------- ---------------- 7,127,515 63,314 60,055 4,146,164 The appointment of Grant Thornton, L.L.P. as the Company's independent auditors for the fiscal year 2001. For Against Abstain Broker Non-Votes --- ------- ------- ---------------- 11,353,455 13,801 29,792 9,758,113 Pursuant to the requirements of the Securities and Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized. Item 6. Exhibits -------- Exhibit No. Description ----------------------- 10.1 Form of Debenture 10.2 Form of Promissory Note Upgrade International Corporation Date: May 15, 2001 -- Daniel Bland, President and Chief Executive Officer, and Secretary Date: May 15, 2001 -- Howard A. Jaffe, Chief Operating and Financial Officer