

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

PATRON SYSTEMS INC  
Form 10QSB  
September 25, 2003

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-QSB

- Quarterly Report Under Section 13 or 15(d) of the Securities Exchange Act of 1934 For the quarterly period ended June 30, 2003
- Transition Report Under Section 13 or 15(d) of the Exchange Act For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-25675

PATRON SYSTEMS, INC.  
(Exact name of small business issuer as specified in its charter)

DELAWARE  
-----  
(State or other jurisdiction of  
incorporation or organization)

74-3055158  
-----  
(IRS Employer Identification No.)

311 BELLE FORET DRIVE, SUITE 150, LAKE BLUFF, IL 60044  
-----

(Address of principal executive offices)

(847) 295-7338  
-----  
(Issuer's telephone number)

-----  
(Former name, former address and former fiscal year,  
if changed since last report)

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PRECEDING FIVE YEARS. Check whether the registrant filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Exchange Act after the distribution of securities under a plan confirmed by a court.  
Yes  No

As of September 25, 2003, there were 34,931,388 shares of the issuer's common stock, par value \$0.01 per share, outstanding.

Transitional Small Business Disclosure Format (Check one): Yes  No

PATRON SYSTEMS, INC.  
INDEX

PART I. FINANCIAL INFORMATION

## Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

ITEM 1. FINANCIAL STATEMENTS

Consolidated Balance Sheets at June 30, 2003 (Unaudited) and December 31, 2002

Unaudited Consolidated Statements of Operations for the Three-Months Ended June 30, 2003 and the period from inception (April 30, 2002) to June 30, 2003

Unaudited Consolidated Statement of Stockholders' Deficit for the period from inception (April 30, 2002) to June 30, 2003

Unaudited Consolidated Statements of Cash Flows for the Three-Months Ended June 30, 2003 and the period from inception (April 30, 2002) to June 30, 2003

Notes to Unaudited Consolidated Financial Statements

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

ITEM 3. CONTROLS AND PROCEDURES

PART II. OTHER INFORMATION

ITEMS 6. EXHIBITS AND REPORTS ON FORM 8-K

SIGNATURES

CERTIFICATIONS

PART I -- FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

CONSOLIDATED BALANCE SHEETS

	JUNE 30, 2003
-----	
(UNAUDITED)	
ASSETS	
CURRENT ASSETS	
Cash and cash equivalents	\$ 300
Loans to TrustWave Corp. and Entelagent Software Corp., net of reserves of \$2,345,639 at June 30, 2003	811,867
-----	
TOTAL CURRENT ASSETS	812,167
DEFERRED COSTS ASSOCIATED WITH PENDING ACQUISITIONS	296,863
-----	
TOTAL ASSETS	\$ 1,109,030
-----	
LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)	
CURRENT LIABILITIES	
Note Payable	\$ 229,900
Accounts payable	1,571,400
Expense reimbursement due to officers and shareholders	407,173
Accrued payroll and payroll related expenses	1,076,488
Advances from Shareholders	1,243,500
Accrued Costs associated with operations in the United Kingdom	215,000
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TOTAL CURRENT LIABILITIES	4,743,461
OBLIGATION UNDER FINANCING ARRANGEMENT	--
STOCKHOLDERS' DEFICIT	
Common stock, par value \$.01 per share, 150,000,000 shares authorized, 34,931,388 and 41,137,417 shares issued and outstanding as of June 30, 2003 and December 31, 2002, respectively	349,314
Additional paid in capital	19,752,984
Shares issued and held in escrow (8,823,529 shares at December 31, 2002)	--
Accumulated Deficit during Developmental Stage	(23,736,729)
TOTAL STOCKHOLDERS' DEFICIT	(3,634,431)
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 1,109,030

The accompanying notes are an integral part of this statement.

1

### CONSOLIDATED STATEMENT OF OPERATIONS (UNAUDITED)

	THREE-MONTHS ENDED JUNE 30, 2003
	-----
REVENUE	\$ --
GENERAL AND ADMINISTRATIVE EXPENSES	1,560,932
CHARGE ASSOCIATED WITH ALLOWANCE FOR TRUSTWAVE LOANS	2,345,639
LOSS FROM OPERATIONS	(3,906,571)
OTHER INCOME (EXPENSE)	
Loss on financing arrangement	--
Interest Income	71,891
LOSS BEFORE INCOME TAXES	(3,834,680)
INCOME TAX BENEFIT	--
	-----

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NET LOSS	\$ (3,834,680)
-----	
NET LOSS PER SHARE-BASIC AND DILUTED	\$ (0.11)
-----	
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING-BASIC AND DILUTED	34,923,036
-----	
	PERIOD FROM INCEPTION (APRIL 30, 2002) TO JUNE 30, 2003
-----	
REVENUE	\$ --
-----	
GENERAL AND ADMINISTRATIVE EXPENSES	5,474,547
CHARGE ASSOCIATED WITH ALLOWANCE FOR TRUSTWAVE BAD DEBT	2,345,639
CHARGE ASSOCIATED WITH ISSUANCE OF STOCK IN REVERSE MERGER TRANSACTION	3,965,726
COMMON STOCK ISSUED FOR BUSINESS DEVELOPMENT CONSULTING SERVICES	4,168,750
STOCK OPTIONS GRANTED FOR SERVICES	4,676,000
-----	
LOSS FROM OPERATIONS	(20,630,662)
OTHER INCOME (EXPENSE)	
Loss on financing arrangement	(3,258,000)
Interest Income	151,933
-----	
LOSS BEFORE INCOME TAXES	(23,736,729)
INCOME TAX BENEFIT	--
-----	
NET LOSS	\$ (23,736,729)
-----	
NET LOSS PER SHARE-BASIC AND DILUTED	\$ (0.73)
-----	
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING-BASIC AND DILUTED	32,581,378
-----	

The accompanying notes are an integral part of this statement.

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CONSOLIDATED STATEMENT OF STOCKHOLDERS' DEFICIT (UNAUDITED)

FOR THE PERIOD FROM INCEPTION (APRIL 30, 2003) TO JUNE 30, 2003

	SHARES OF COMMON STOCK	P CO
BALANCE AT INCEPTION (APRIL 30, 2002)	--	\$
Issuance of founders shares	25,000,000	
Shares issued to predecessor in exchange transaction	2,687,200	
Issuance of common stock in share exchange transaction	2,201,688	
Common stock issued in lieu of cash for services	2,425,000	
Stock options issued in lieu for cash for services	--	
Issuance of common stock as collateral to anticipated financing	8,823,529	
Net loss for period ended December 31, 2002	--	
Balance, December 31, 2002	41,137,417	
Issuance of common stock in private placement transactions	1,162,500	
Common stock issued under Accommodation Agreement	1,200,000	
Issuance of common stock as collateral to anticipated financing	5,769,231	
Adjustment to Par Value for Redomestication to Delaware		
Common stock retired due to non-delivery of financing	(14,592,760)	
Common stock issued in lieu of cash for services	2,250,000	
Common stock retired due to services contract termination	(2,120,000)	
Common stock issued in private placement transaction	125,000	
Net loss	--	
BALANCE, JUNE 30, 2003	34,931,388	\$

	SHARES HELD IN ESCROW	DEFIC D DEVE
BALANCE AT INCEPTION (APRIL 30, 2002)	\$ --	\$
Issuance of founders shares	--	
Shares issued to predecessor in exchange transaction	--	
Issuance of common stock in share exchange transaction	--	
Common stock issued in lieu of cash for services	--	
Stock options issued in lieu for cash for services	--	
Issuance of common stock as collateral to anticipated financing	(13,235,293)	
Net loss for period ended December 31, 2002	--	
Balance, December 31, 2002	(13,235,293)	
Issuance of common stock in private placement transactions	--	
Common stock issued under Accommodation Agreement	--	

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Issuance of common stock as collateral to anticipated financing	(7,557,693)	
Adjustment to Par Value for Redomestication to Delaware	--	
Common stock retired from due to non-delivery of financing	20,792,986	
Common stock issued in lieu of cash for services	--	
Common stock retired due to services contract termination	--	
Common stock issued in private placement transaction	--	
Net loss for the six months ended June 30, 2003	--	
BALANCE, JUNE 30, 2003	\$	-- \$

The accompanying notes are an integral part of this statement.

3

### CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)

	SIX-MONTHS ENDED JUNE 30, 2003	PERIOD FROM (APRIL 30 JUNE 30, 2002)
	-----	-----
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	\$ (7,408,391)	\$
	-----	-----
Adjustments to reconcile net loss to net cash provided in operating activities:		
Charge associated with liabilities and loans	2,345,410	
Non-cash charge associated with share exchange transaction	--	
Common stock issued in lieu of cash for services	436,800	
Stock options issued in lieu of cash for services	--	
Non-cash loss on financing arrangement	2,210,272	
Changes in assets and liabilities:		
Accounts payable and other accruals	586,126	
Expense reimbursement due to officers and shareholders	(45,954)	
Accrued payroll and payroll related expenses	416,630	
	-----	-----
Total adjustments	5,949,284	
	-----	-----
NET CASH USED IN OPERATING ACTIVITIES	(1,459,107)	
	-----	-----
CASH FLOWS USED IN INVESTING ACTIVITIES		
Loans to TrustWave Corp. and Entelagent Software Corp.	(1,968,752)	
Deferred costs associated with pending acquisitions	(84,354)	
	-----	-----

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NET CASH USED IN INVESTING ACTIVITIES	(2,053,106)	
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from issuance of notes payable	--	
Proceeds from issuance of common stock	2,897,151	
Advances from shareholders	615,000	
Proceeds received under financing arrangement	--	
Net Cash Provided by Financing Activities	3,512,151	
NET CASH INCREASE (DECREASE)	(62)	
CASH AND CASH EQUIVALENTS, beginning of period	362	
	-----	-----
CASH AND CASH EQUIVALENTS, end of period	\$ 300	\$
	-----	-----

The accompanying notes are an integral part of this statement.

4

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE A -- GENERAL

In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of normal recurring accruals and adjustments to reserve certain loans receivable at June 30, 2003 (see Note D)) necessary to present fairly the financial position of Patron Systems, Inc., and its subsidiaries at June 30, 2003 and December 31, 2002, and the results of its operations and its cash flows for the three- and six-month periods ended June 30, 2003.

Interim results of operations for the period from inception (April 30, 2002) through June 30, 2002 have been omitted as expenses associated with the commencement of operations during this period were nominal in both dollar amount and in comparison to activity later in 2002 and year to date in 2003, making comparisons between periods not meaningful.

The results of operations presented are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2003. The significant accounting principals and practices followed by Patron Systems, Inc. are set forth in the Notes to Consolidated Financial Statements in Patron System's Annual Report on Form 10-KSB for the year ended December 31, 2002.

#### NOTE B -- ORGANIZATION AND BUSINESS

Patron Systems, Inc. (herein referred to as "Systems" or the "Company") is a successor entity to Combined Professional Services, Inc., a Nevada corporation originally formed in October 1995 (CPS), which later changed its name in a share exchange to Patron Holdings, Inc. (Holdings). Holdings (as CPS) was originally formed to provide corporate financial services to other business entities, but abandoned that business plan shortly after formation. Holdings, therefore, has never had business operations or revenue.

On October 11, 2002, Holdings (as CPS), Systems and the stockholders of Systems

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consummated a share exchange (Share Exchange) pursuant to an Amended and Restated Share Exchange Agreement, whereby Holdings (as CPS) issued to each Systems stockholder, on a one-for-one basis and in exchange for all of the outstanding shares of Systems capital stock, an aggregate of 25,400,000 shares of Holdings (as CPS) common stock. Upon the closing of the Share Exchange, Systems' stockholders held approximately 85 percent of the outstanding capital stock of Holdings (as CPS), and Systems became a wholly-owned subsidiary of Holdings (as CPS). The share exchange was accounted for as a reverse merger whereby Systems, as the surviving company, was treated as the acquirer for financial statement purposes.

On March 26, 2003, Holdings merged with and into Systems, for the purpose of changing its state of incorporation from Nevada to Delaware (Redomestication Merger). Systems became the surviving corporation of the Redomestication Merger, and its Second Amended and Restated Certificate of Incorporation, Amended and Restated Bylaws are the governing documents of the surviving corporation. Systems' Board of Directors are the governing body of the Surviving Corporation.

Patron Systems, Inc., a Delaware corporation, was formed in April 2002 to provide comprehensive, end-to-end information security solutions to global corporations and government institutions. Systems' founders intended to raise capital on a private equity basis, but determined that there was a need for public currency to achieve their growth path. Systems identified CPS during this process and determined that CPS was well-suited to provide Systems with its public currency because of its lack of operational history, affording Systems an open platform from which to grow, without the necessity of divesting existing operations or incurring liabilities as a result of existing operations.

The Company has yet to begin revenue-generating operations and, as such, is a development stage company. Since its inception, the Company has reported a net loss of approximately \$23,700,000 principally associated with expenses related to the formation of the Company, assembling its management team, and capital formation and acquisition activities consistent with its business plan. A significant portion of this net loss can be attributed to non-cash capital stock transactions, such as the issuance of capital stock or stock options in lieu of cash for services.

5

### NOTE C -- SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

#### PRINCIPLES OF CONSOLIDATION AND BASIS OF PRESENTATION

Effective with the reincorporation merger on March 26, 2003, Patron Holdings, Inc., merged into its wholly owned Delaware subsidiary, Patron Systems, Inc. As such, the accompanying financial statements represent the accounts of Patron Systems, Inc., and its two subsidiaries, TWC Acquisition Inc. and ESC Acquisition Inc. The accompanying financial statements are unaudited. However, management believes they contain all necessary adjustments and disclosures to be presented in accordance with generally accepted accounting principles.

#### ACQUISITION COSTS

The Company has incurred certain expenses, principally legal fees, in connection with the pending acquisitions described in Note D, which have been capitalized and deferred pending the completion of each acquisition. Upon closing, such costs will be included in the purchase price of each respective target company and allocated to the assets received and obligations assumed. In the event a pending acquisition does not occur, such costs will be expensed at that time.



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### START UP COSTS

All expenses incurred in connection with formation of the Company and related start up activities have been expensed as incurred and are included in general and administrative expenses in the accompanying consolidated financial statements.

### STOCK OPTION PLANS

The Company accounts for employee stock option grants using the intrinsic method in accordance with Accounting Principles Board (APB) Opinion No. 25 "Accounting for Stock Issued to Employees" and accordingly associated compensation expense, if any, is measured as the excess of the underlying stock price over the exercise price on the date of grant. The Company complies with the disclosure option of Statement of Financial Accounting Standards (SFAS) No. 123 "Accounting for Stock Based Compensation", as amended by SFAS No. 148 "Accounting for Stock-Based Compensation--Transition and Disclosure" which requires pro-forma disclosure of compensation expense associated with stock options under the fair value method.

The following sets forth proforma information as if the Company were using the fair value method under SFAS No. 123 for the six months ended June 30, 2003 and the period from inception to June 30, 2003:

	Six Months Ended June 30, 2003	Period Incept (April 30, June 30,
	-----	-----
Net Loss, as reported	\$ (7,408,391)	\$ (23,73
Stock-based employee compensation cost under the fair value method of SFAS No. 123	10,072	6
	-----	-----
Pro-Forma Net Loss	\$ (7,418,463)	\$ (23,79
	-----	-----
Pro-Forma Net Loss per Share-Basic and Diluted	(.22)	

6

### NET LOSS PER SHARE

Basic net loss per common share is computed by dividing net loss by the weighted-average number of common shares outstanding during the period. Diluted net loss per common share also includes common stock equivalents outstanding during the period if dilutive. Diluted net loss per common share has been computed by dividing net loss by the weighted-average number of common shares outstanding without an assumed increase in common shares outstanding for common stock equivalents; as such common stock equivalents are anti-dilutive. Common stock equivalents at June 30, 2003, consist primarily of 5,010,618 vested stock options.

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### USE OF ESTIMATES IN PREPARING FINANCIAL STATEMENTS

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and revenue and expenses during the reporting period. Actual results could differ from those estimates.

### NOTE D--PENDING ACQUISITIONS SUBJECT TO CLOSING

#### TRUSTWAVE CORP.

On November 23, 2002, Patron Systems, Inc., TWC Acquisition, Inc., a Maryland corporation and wholly-owned subsidiary of Patron Systems Inc., (TrustWave Mergerco), and TrustWave Corp., a Maryland corporation (TrustWave), entered into an Agreement and Plan of Merger, as subsequently amended, (the TrustWave Merger Agreement) whereby TrustWave will be merged with and into TrustWave Mergerco a wholly-owned subsidiary of Patron Systems, Inc. (the TrustWave Merger). Patron Systems, Inc. TrustWave Mergerco and TrustWave also concurrently entered into a Supplemental Agreement, as amended (the TrustWave Supplemental Agreement), along with certain shareholders of TrustWave. Upon the consummation of the TrustWave Merger, shareholders of TrustWave will receive, in the aggregate: (1) \$22,000,000 in cash, \$10,000,000 of which will be paid at the closing of the TrustWave Merger and \$12,000,000 of which will be paid no later than three months after the closing of the TrustWave Merger; and (2) 15,000,000 shares of Patron System's common stock, subject to a one-time increase of up to 100 percent in the event that the shares of Patron's common stock fails to trade at or above \$12 per share, on average, over the 21 days prior to and including the first anniversary of the closing date. In addition, Patron will issue stock options to current TrustWave option holders. The exact number of options will be determined at the closing and will be deducted from the closing common stock consideration.

The TrustWave Merger has been approved by the Boards of Directors of Patron Systems, TrustWave Mergerco, TrustWave, and TrustWave's shareholders. The TrustWave Merger is intended to be a tax-free reorganization under the Internal Revenue Code. In connection with the consummation of the TrustWave Merger, certain executive officers of TrustWave will execute employment agreements with Patron. The closing of the acquisition is subject to several closing conditions including the receipt of adequate financing to complete the acquisition and fund certain working capital needs of TrustWave.

Recently Patron received notification from TrustWave of its intent to terminate the TrustWave Merger Agreements. The Company has rejected the request for termination of the TrustWave Merger by TrustWave due to its failure to meet key provisions of the Merger Agreement and Supplemental Agreements, as amended. The Company is pursuing binding arbitration as set forth in the agreements. However, it is still the Company's wish to find a mutually agreeable set of terms to complete this transaction.

In connection with this transaction, Patron is required to provide working capital financing to TrustWave. Advances under such notes bear interest at 10 percent per annum and are repayable on demand. Total outstanding advances under such notes at June 30, 2003 were \$2,240,000 and approximately \$110,000 in accrued interest. The Company has demanded repayment of these notes. As of the date of filing, TrustWave has yet to make any payments and is in default on these notes. The Company intends to pursue collection of these notes through all available legal means. While the Company believes that these notes will ultimately be collected, its ability to collect these amounts may be dependent upon the outcome of legal action taken by the Company. As a result, a reserve has been provided for the full balance due. Should the Company collect funds

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from TrustWave, the Company will reverse the reserves established accordingly.

7

TrustWave, founded in 1995, provides enterprise information assurance and security services and solutions to corporate, educational and government customers. In early 2002, TrustWave began work on a contract with a Fortune 100 financial services company to conduct security compliance audits and ongoing remote vulnerability testing using TrustWave's proprietary technology and products.

### ENTELAGENT SOFTWARE CORP.

On November 24, 2002, Patron Systems, ESC Acquisition, Inc., a California corporation and wholly-owned subsidiary of Patron Systems Inc. (Entelagent Mergerco), and Entelagent Software Corp., a California corporation (Entelagent), entered into an Agreement and Plan of Merger, as amended (the Entelagent Merger Agreement) whereby Entelagent Mergerco will be merged with and into Entelagent with Entelagent surviving as a wholly owned subsidiary of Patron Systems Inc. (the Entelagent Merger). Patron, Entelagent Mergerco and Entelagent also concurrently entered into a Supplemental Agreement, as amended (the Entelagent Supplemental Agreement). Upon the consummation of the Entelagent Merger, shareholders of Entelagent will receive, in the aggregate, 1,800,000 shares of Patron and Patron will assume certain debts and obligations of Entelagent.

The Entelagent Merger has been approved by the Boards of Directors of Patron, Entelagent Mergerco and Entelagent. The Entelagent Merger is intended to be a tax-free reorganization under the Internal Revenue Code. In connection with the consummation of the Entelagent Merger, certain executive officers of Entelagent will execute employment agreements with Patron. The closing of the acquisition is subject to certain closing conditions, including approval of the transaction by Entelagent shareholders, the consummation of Patron's merger with TrustWave and obtaining funding for the additional working capital needs of Entelagent. While management believes the Company will be successful in its efforts to consummate the TrustWave Merger, the Company intends to pursue an Amendment to its merger agreements with Entelagent to remove the TrustWave merger as a condition precedent to closing the transaction with Entelagent.

Working capital advances under such notes bear interest at 10 percent per annum and are repayable upon demand. Total outstanding advances under such notes at June 30, 2003, were \$780,000 plus accrued interest of approximately \$31,767. Management periodically assesses such loans for collectibility and as of June 30, management believes the amounts loaned to Entelagent are fully collectible. As such, an allowance has not been established. However, should matters arise that indicate that the Company may not collect all or a portion the balance of such loans, a charge to earnings may result.

Subsequent to the closing of this transaction, the Company will be obligated to grant 440,000 common stock options to certain employees and non-employee consultants of Entelagent.

Entelagent is an information technology products and services company founded in 1996. Entelagent's products and services are focused on e-mail management solutions, including monitoring and data mining with a particular focus on ensuring compliance with laws and regulations in the financial services and brokerage industries.

### NOTE E -- RELATED PARTY TRANSACTIONS

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### ADVANCES FROM SHAREHOLDERS

Since its inception, the Company has obtained financing from certain shareholders for working capital needs. At June 30, 2003, the face amount of notes with these shareholders was \$1,243,500 and related accrued interest of \$86,214 has been included in accounts payable. These advances bear interest at rates ranging from 8 percent to 10 percent per annum and are due on demand.

### REIMBURSEMENTS OF EXPENSES INCURRED BY SHAREHOLDERS, OFFICERS AND DIRECTORS

Certain shareholders, officers and directors of the Company have incurred operating expenses totaling \$1,072,375 on the Company's behalf. Such expenses have been recorded in the accompanying consolidated financial statements with a corresponding obligation to reimburse the shareholders, officers and directors. Included in such expenses is approximately \$60,000 of expenses incurred by a founder prior to incorporation of the Company for which the Company has agreed to reimburse the founder. As of June 30, 2003, approximately \$665,000 in reimbursements has been paid to the shareholders, officers and directors.

8

### NOTE F -- NOTES PAYABLE

#### CONVERTIBLE NOTES PAYABLE

In 2002, the Company borrowed an aggregate amount of \$145,000 from four unrelated third parties. The notes bear interest at 8 percent and are convertible into shares of the Company's common stock with the conversion price based on the underlying fair market value at the dates that the notes are settled.

#### DEMAND NOTES PAYABLE

In 2002, the Company borrowed an aggregate amount of \$85,000 from two unrelated third parties under demand notes payable, which bear interest at 10 percent.

#### ACCOMMODATION AGREEMENTS

In November 2002, the Company entered into a financing arrangement with a third party financial institution (the Lender), which called for the Company to borrow \$950,000 under a note to be collateralized by the pledge of 950,000 shares of the Company's common stock from five different stockholders. In connection with this arrangement, the Company executed a series of Accommodation Agreements with the five stockholders wherein each stockholder pledged shares in return for the right to receive on or before June 30, 2003 the return of the pledged shares, or replacement shares in the event of foreclosure, and one additional share of common stock for every four shares as compensation. The Company also agreed to use "best efforts" to register these shares with the US Securities and Exchange Commission 12 months from the date of issue.

In December 2002, the Company received approximately \$450,000 of proceeds under the note and provided the Lender the pledged shares. Since that date, no additional proceeds have been provided by the Lender and repeated attempts have been made by the Company to secure the additional proceeds. The Company plans to take the necessary legal steps to either enforce the loan or secure the return of the pledged shares.

In the accompanying financial statements as of June 30, 2003, the Company has effectively accounted for these events as a foreclosure on the loan collateral by the Lender. On March 13, 2003, the Company replaced the shares to the five

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stockholders who pledged shares under the Accommodation Agreements for a total of 1,200,000 shares of Patron common stock. The value of the replacement shares issued totaled \$3,708,000. As a result, the Company recorded a loss of approximately \$2,200,000 upon issuance of the replacement shares for difference between the value of the shares issued and the amount of loss accrued in its 2002 financial statements.

### SECURED PROMISSORY NOTE

In December 2002, the Company entered into a collateral loan agreement and promissory note with Mercatus & Partners, Ltd. in the amount of \$3 million. On January 3, 2002, the Company entered into a second promissory note with Mercatus & Partners, Ltd. in the amount of \$1.5 million. As of April 29, 2003, the Company has not borrowed any amounts under these arrangements. The \$3 million note was collateralized by 8,823,529 shares of restricted common stock, which were placed in a custodial account for the benefit of the Lender as security for the loan. The \$1.5 million note was collateralized by 5,769,231 shares of restricted common stock, which were also placed in a custodial account for the benefit of the Lender to securitize the loan. Shares associated with the \$3 million and the \$1.5 million notes have been reflected as shares issued and outstanding and held in escrow in the accompanying consolidated statement of stockholders' deficit.

On June 30, 2003, the Company terminated the collateral loan agreements and promissory notes for failure of Mercatus & Partners, Ltd. to deliver funds. The Company has requested that all collateral shares be returned to the Company's transfer agent for cancellation and retirement, which will reduce the number of issued and outstanding shares of the Company by 14,592,760 shares. These shares have been excluded from the number of issued and outstanding shares as of June 30, 2003.

9

### FUNDS RECEIVED FROM COMPANY OFFICER

In March 2003, an officer of the Company (the "officer") borrowed \$635,000 from third parties and used these funds to pay certain legitimate business expenses of the Company. This was done without the knowledge of the CEO and CFO.

Pending determination by Management and the Board as to whether the funds were obtained personally by the officer and deposited in a Company account or whether this officer obtained the funds on behalf of the Company, these transactions and the related funds, as well as the subsequent disbursement of funds to pay liabilities of the Company have been reflected in the financial statements as they occurred inasmuch as the funds were received into and disbursed out of a Company account. The Company's recognizes its obligation to repay the principal due either to the officer or to the third parties.

The funds in the amount of \$635,000 received by the officer were used to reimburse certain creditors and officers of the Company for expenses paid on the Company's behalf, to fund certain expenses of its start up operation in the United Kingdom, and to advance additional funds to Entelagent Software Corp. The remaining cash balance in this account is nominal at June 30, 2003 and the account has since been closed. Because these transactions were not known by or approved by the CEO or CFO, a breach of the Company's internal controls occurred. Management, the Board and legal counsel are evaluating actions

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necessary to prevent a similar breach in the future.

### NOTE G -- PRIVATE PLACEMENTS

In March 2003, the Company completed three separate private placements of restricted securities with unaffiliated third parties. A total of 1,162,500 shares were purchased in a range of \$2.00 to \$4.00 per share. Total proceeds were approximately \$2,600,000. These proceeds were used principally as working capital advances to TrustWave Corp. and Entelagent Software Corp., including \$1,000,000 to TrustWave and \$250,000 to Entelagent. The remainder of the proceeds were used for partial payment of professional fees, as well as reimbursement of shareholder and officer expenses incurred on behalf of the Company. On August 27, 2003, the Company received a letter from the investor who purchased 1,000,000 shares for \$2,000,000 demanding rescission of his investment. It is the view of the Company that there are no grounds for rescission.

On April 4, 2003, Patron completed one private placement of restricted securities with an unaffiliated third party. 125,000 shares were purchased at a price of \$2.00 per share. Total proceeds under this private placement were \$250,000 and were used for partial repayment of accrued Company expenses, as well as reimbursement of shareholder expenses incurred on behalf of the Company. \$50,000 in proceeds were used as a working capital advance to Entelagent Software Corp.

The term sheets for 1,125,000 shares contain a provision for Patron to commit to file a registration statement for these shares within two weeks of the closing of the TrustWave Merger and to use best efforts to ensure that the registration statement is declared effective within ninety days of the closing of the TrustWave Merger. As of September 25, 2003 a registration statement for these shares has not been filed.

### NOTE H -- CONSULTING AGREEMENTS

Patron, in an attempt to generate merger and acquisition prospects quickly, has issued shares of Common Stock which it has registered on registration statement on Form S-8 to compensate consultants. On March 31, 2003, Patron entered into consulting agreements with M. Rashid Qajar, who currently holds more than 5% of our outstanding voting stock, and Paul Harary of Security Management Partners. The term of each agreement is two years. The consulting services which were to be provided by Mr. Qajar were to advise and consult with Patron regarding general business matters including, but were not limited to, development of an international business strategy, the evaluation and analysis of management needs and identifying and introducing Patron to prospective merger, asset, business or other acquisition candidates. The consulting services which were to be provided by Mr. Harary were to include, but not limited to, the identification of potential candidates in the enterprise security service and technology field for acquisition by Patron. For and as consideration for the services provided pursuant to the consulting agreements, Patron has agreed to issue to Mr. Qajar 2,050,000 shares of Patron Common Stock and Mr. Harary 200,000 shares of Patron Common Stock. On April 2, 2003, Patron registered 2,250,000 shares of Patron Common Stock on Form S-8. Mr. Qajar has agreed to refrain from transferring 1,500,000 of his shares of Patron common stock for a period of twelve months.

On June 16, 2003, the Company cancelled the consulting agreements with Mr. Qajar and Mr. Harary. Accordingly, the Company filed an amendment to the registration statement on Form S-8 to deregister 2,120,000 shares of common stock. The Company has requested that Mr. Harary return 140,000 shares of common stock. The Company is negotiating a reasonable compensatory arrangement for services rendered with Mr. Qajar, which will include the return of 1,980,000 shares of common stock. In connection with the termination of these consulting agreements and subsequent deregistration of shares of common stock, the Company has

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incurred a charge of approximately \$437,000.

### NOTE I -- SUBSEQUENT FUNDING EVENT

On September 25, 2003, the Company finalized the terms of a \$50 million private placement of securities consisting of: (i) \$15 million of common stock at a price of \$0.50 per share or 30 million shares, and (ii) \$35 million of convertible preferred stock. The preferred stock has a 5% dividend payable-in-kind and is convertible into common stock at an effective conversion price of \$0.50 per common share. These shares do not have any special registration rights and funding is not dependent on the closing of any specific transaction. In addition, the Company granted to the investors an option for 90 days following the closing of the private placements to invest an additional \$50 million by purchasing up to an additional 100 million shares of common stock at a price of \$0.50 per share. The option period can be extended by mutual agreement. The net proceeds from the private placements, after deducting transactional costs, are expected to be approximately \$49 million (not assuming the optional shares). Patron is negotiating with the investor to lock up all shares for a period of three years. We intend to use the net proceeds for acquisitions and general corporate purposes.

As a condition of this funding process, the Company has agreed to a series of changes, including a significant reduction in the number of founders' shares and management options and reconstituting Patron's management team and Board of Directors. To this end, Rich Linting, Brett Newbold and Marie Meisenbach Graul have resigned from Patron, and Rich Beggs, Warren Luke and Anthony Carbone have left the board of directors. Patron is currently in active discussions with replacement candidates for the board and management team.

10

### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION.

#### FORWARD-LOOKING STATEMENTS

The following discussion and analysis of the financial condition and results of operation for Patron Systems, Inc. should be read in conjunction with our unaudited financial statements and related notes appearing elsewhere in this report. This discussion contains forward-looking statements and information relating to Patron Systems, Inc. our industry and planned business operations as well as other information security businesses that involve risks and uncertainties. The statements contained in this report that are not historical statements of fact are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 (Securities Act) and Section 21E of the Securities Exchange Act of 1934, as amended (Exchange Act). Forward-looking statements include, among other things, statements regarding our expectations, beliefs, intentions or strategies regarding the future. All forward-looking statements included in this report are based on information available to us up to and including the date of this document, and we expressly disclaim any obligation to update or alter our forward-looking statements, whether as a result of new information, future events or otherwise. Our actual results could differ significantly from those anticipated in these forward-looking statements as a result of certain factors, including those set forth below, under the caption "Risk Factors" and elsewhere in this report.

#### GENERAL INFORMATION AND OVERVIEW

Patron Systems, Inc. is a successor entity to Combined Professional Services, Inc., a Nevada corporation originally formed in October 1995 ("CPS"), which later changed its name in a share exchange to Patron Holdings, Inc. ("Holdings"). Holdings (as CPS) was originally formed to provide corporate financial services to other business entities, but abandoned that business plan

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shortly after formation. Holdings, therefore, has never had business operations or revenue.

Patron was formed as a Delaware corporation in April 2002 to provide comprehensive, end-to-end information security solutions to global corporations and government institutions. Patron's founders intended to raise capital on a private equity basis, but determined that there was a need for a public company currency to achieve their growth plan. Patron identified CPS during this process and determined that CPS was well-suited to provide Patron with its public currency because of its lack of operational history, affording Patron an open platform from which to grow, without the necessity of divesting existing operations or incurring liabilities as a result of existing operations.

On October 11, 2002, Holdings (as CPS), Patron and the stockholders of Patron consummated a share exchange pursuant to an Amended and Restated Share Exchange Agreement, whereby Holdings (as CPS) issued to each Patron stockholder, on a one-for-one basis and in exchange for all of the outstanding shares of Patron capital stock, an aggregate of 25,400,000 shares of Holdings (as CPS) common stock. Upon the closing of the share exchange, Patron stockholders held approximately 85 percent of the outstanding capital stock of Holdings (as CPS), and Patron became a wholly owned subsidiary of Holdings (as CPS). The share exchange was accounted for as a reverse merger whereby Patron, as the surviving company, was treated as the acquirer for financial statement purposes.

On March 26, 2003, Holdings merged with and into Patron for the purpose of changing its state of incorporation from Nevada to Delaware. Patron became the surviving corporation of this redomestication merger, and its Second Amended and Restated Certificate of Incorporation, Amended and Restated Bylaws are the governing documents of the surviving corporation. Systems' Board of Directors are the governing body of the surviving corporation.

Prior to the date of the redomestication merger, Patron had no material assets or business operations. Patron's principal activities since its formation in April 2002 consisted of the development of its business plan, capital raising and evaluation and negotiation of potential acquisitions.

11

### PLAN OF OPERATION

During the second quarter ended June 30, 2003, the Company incurred a net loss of \$7,408,391. The Company had commenced operations upon incorporation on April 30, 2002 and its operations through June 30, 2002 resulted in only nominal activity incident to the start up of its business, making comparison to the comparable period for 2003 not meaningful. A major element of the net loss in the 2003 period was general administrative expenses of \$1,560,932, comprised of management salaries and associated expenses incidental to the development of its business and a charge of \$100,000 representing an estimated liability associated with expenses incurred by a consultant to the company who is currently working to secure funding necessary to close Patron's merger and acquisition transactions. Also, the Company recognized an allowance for failure of TrustWave to repay demand notes for which it is in default, totaling \$2,345,639 in principal and interest.

During the next 12 months, Patron intends to implement its business plan to offer trusted security services and next generation integrated security products through acquisitions and internal growth. Patron intends to work with organizations to ensure that global enterprises implement information security policies, procedures and products that result in "trusted" information



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environments. Patron expects to offer information security and vulnerability assessments, certification programs, remediation, implementation, training, monitoring and management services.

In executing its current plans, Patron intends to identify and pursue potential acquisition targets consistent with its business plan; seek additional financing to fund ongoing business operations and to support its acquisitions strategies; develop management and information systems and technology to support operations; and attract and retain qualified personnel. Patron's ability to pursue this plan and to carry out its proposed business activities is dependent upon its ability to implement its acquisitions strategies, and to operate acquired companies efficiently, and to obtain required financing.

Patron has yet to begin revenue generating operations and as such is a development stage company. Since its inception, Patron has reported a net loss of approximately \$23,721,000, principally associated with expenses related to its formation, assembling its management team, and capital formation and acquisition activities consistent with its business plan.

Patron has 2 corporate employees as of the date of this report. Patron intends to hire additional employees during the next 12 months as it completes pending acquisitions and executes its business plan, which will be dependent upon Patron's ability to raise necessary funding.

### PENDING ACQUISITIONS

Patron intends to consummate the merger with TrustWave Corp. as soon as possible subject to Patron's satisfaction of certain closing conditions under the Agreement and Plan of Merger dated November 23, 2002 as amended. As of the date of this report, the closing date for the TrustWave merger has been verbally extended pending finalization of financing and merger terms. Patron's wholly-owned subsidiary will merge with and into TrustWave, with TrustWave surviving as a wholly owned subsidiary of Patron. At the closing of the merger with TrustWave, shareholders of TrustWave will receive, in the aggregate: (1) \$22,000,000 in cash, \$10,000,000 of which will be paid at the closing of the merger and the balance of which will be paid three months after the closing; and (2) approximately 15,000,000 shares of Patron's common stock, subject to a one-time increase of up to 100 percent in the event that the shares of the Patron's common stock fail to trade at or above \$12 per share, on average, over the 21 days prior to and including the first anniversary of the closing date. Included in the 15,000,000 shares, Patron will issue approximately 2,900,000 stock options to current TrustWave option holders. In connection with this transaction, Patron provided working capital financing to TrustWave. Total outstanding advances at June 30, 2003, were \$2,240,000.

Recently Patron received notification from TrustWave of its intent to terminate the TrustWave Merger Agreements. The Company has rejected the termination of the TrustWave Merger by TrustWave due to its failure to meet key provisions of the Merger Agreement and Supplemental Agreements, as amended. The Company is pursuing binding arbitration as set forth in the agreements. However, it is the Company's wish to find a mutually agreeable set of terms to complete this transaction.

In connection with this transaction, Patron is required to provide working capital financing to TrustWave. Advances under such notes bear interest at 10 percent per annum and are repayable on demand. Total outstanding advances

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under such notes at June 30, 2003 were \$2,240,000 and approximately \$110,000 in accrued interest. The Company has demanded repayment of these notes. As of the date of filing, TrustWave has yet to make any payments and is in default on these notes. The Company intends to pursue collection of these notes through all available legal means. While the Company believes that these notes will ultimately be collected, legal action may be required. Accordingly, the Company has recorded a reserve against both the principal and interest of the notes outstanding. Should the Company collect funds from TrustWave, we will adjust the related reserve for the amounts collected in the future.

On November 24, 2002, Patron, ESC Acquisition, Inc., a California corporation and wholly-owned subsidiary of Patron, and Entelagent Software Corp., a California corporation, entered into an Agreement and Plan of Merger whereby ESC Acquisition will be merged with and into Entelagent with Entelagent surviving as a wholly owned subsidiary of Patron. Patron, ESC Acquisition and Entelagent also concurrently entered into a Supplemental Agreement. Upon the consummation of the Entelagent Merger, shareholders of Entelagent will receive, in the aggregate, 1,800,000 shares of Patron's Common Stock and will assume certain debts and obligations of Entelagent. The closing of the acquisition is subject to several closing conditions, including approval of the transaction by Entelagent's shareholders.

Subsequent to the closing of this transaction, Patron will be obligated to grant 440,000 common stock options to certain employees and non-employee consultants of Entelagent.

In connection with this transaction, Patron agreed to provide working capital financing to Entelagent. Advances under such notes bear interest at 10 percent per annum and are repayable upon demand. Total outstanding advances under such notes at June 30, 2003, were \$780,000.

### LIQUIDITY AND CAPITAL RESOURCES

Patron believes that the \$50 million in financing, finalized on September 25, 2003 will be sufficient to fund operations for the foreseeable future.

### CONSULTING AGREEMENTS

Patron, in an attempt to generate merger and acquisition prospects quickly, has issued shares of Common Stock which it has registered on registration statements on Form S-8 to compensate consultants. On March 31, 2003, Patron

13

entered into consulting agreements with each M. Rashid Qajar, who currently holds more than 5% of our outstanding voting stock, and Paul Harary of Security Management Partners. The term of each agreement is two years. The consulting services to be provided by Mr. Qajar were to advise and consult with Patron regarding general business matters including, but not limited to, development of an international business strategy, the evaluation and analysis of management needs and identifying and introducing Patron to prospective merger, asset, business or other acquisition candidates. The consulting services which were to be provided by Mr. Harary include, but were not limited to, the identification of potential candidates in the enterprise security service and technology field for acquisition by Patron. For and as consideration for the services provided pursuant to the consulting agreements, Patron agreed to issue to Mr. Qajar 2,050,000 shares of Patron Common Stock and Mr. Harary 200,000 shares of Patron

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Common Stock. On April 2, 2003, Patron registered 2,250,000 shares of Patron Common Stock on Form S-8. Mr. Qajar agreed to refrain from transferring 1,500,000 of his shares of Patron common stock for a period of twelve months.

On June 16, 2003, the Company cancelled the consulting agreements with Mr. Qajar and Mr. Harary. Accordingly, the Company filed an amendment to the registration statement on Form S-8 to deregister 2,120,000 shares of common stock. The Company has requested that Mr. Harary return 140,000 shares of common stock. The Company is negotiating a reasonable compensatory arrangement for services rendered with Mr. Qajar, which will include the return of 1,980,000 shares of common stock.

In connection with the termination of these consulting agreements and subsequent deregistration of shares of common stock, the Company has incurred a charge of approximately \$437,000.

### HISTORIC FINANCINGS

#### STOCKHOLDER ADVANCES

Patron has been financed to date by a group of stockholders and private investors with "seed" capital. At June 30, 2003, the face amount of notes with stockholders was \$608,500 with related accrued interest of \$84,296. Each of these advances bears interest at rates ranging from 8 percent to 10 percent per annum and is due on demand. In addition, certain of Patron's stockholders and officers have incurred operating expenses totaling approximately \$1,072,375. In addition, through June 30, 2003, Patron borrowed an aggregate amount of \$230,000 from six unrelated parties. Four of the notes representing this debt bear interest at a rate of 8 percent per annum and are convertible into shares of Patron Common Stock, with the conversion price based on the fair market value of such shares on the date on which the notes are converted. Two of the notes representing this debt are demand notes accruing interest at a rate of 10 percent per annum.

#### ACCOMMODATION ARRANGEMENTS

In November 2002, Patron (as successor to Holdings) entered into a financing arrangement with a third party (subsequently amended), which called for Patron to borrow \$950,000 pursuant to a note secured by a pledge by five of its stockholders of 950,000 shares of Patron common stock. In connection with this arrangement, Patron executed a series of Accommodation Agreements with the pledging stockholders, whereby each pledgor pledged shares in return for the right to receive, on or before June 30, 2003, the return of the pledged shares plus additional shares, for a total of 1,200,000 shares of Patron Common Stock. In December 2002, Patron received \$450,000 of proceeds under the note, and provided the lender with all of the pledged shares. To date, Patron has not received the remaining \$500,000 commitment. Patron intends to take all necessary actions to either enforce the loan or secure the

14

return of the pledged shares. Patron issued the replacement shares of Patron Common Stock to the pledging stockholders on March 13, 2003, for a total non-cash charge of \$3,258,000.

#### MERCATUS & PARTNERS, LTD.

In December 2002, Patron entered into a collateral loan agreement and promissory

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note with Mercatus & Partners, Ltd. ("Mercatus"), a financing group, in the amount of \$3 million. On January 2, 2003, Patron entered into a second promissory note with Mercatus in the amount of \$1.5 million. As of the date here, Patron has not borrowed any amounts under these arrangements. Borrowings on the \$3 million note are collateralized by 8,823,529 shares of common stock, which have been placed in a custodial account with UBS Bank in Switzerland for the benefit of the lender as security for the loan. Borrowings on the \$1.5 million note are collateralized by 5,769,231 shares of common stock, which have also been placed in a custodial account for the benefit of the lender as security to the loan. Interest on amounts borrowed accrues at 5.5 percent per annum. Patron has agreed to pay fees of 3% to the lender and two months principal and interest in advance. The term of the loan is five years. Interest only payments will be due in the first year after funding of the loan. Aggregate monthly principal payments of \$93,750 will be due beginning February 2004. There is an early termination charge for prepayment. Mercatus also requires a "key man" life insurance policy naming it as beneficiary and matching the principal balance of the loan on a decreasing basis. Patron is also required within 90 days of a loan drawdown to enter into good faith negotiations to establish a warrant or option position.

As of the date hereof, Mercatus had not provided funding under the terms of the collateral loan agreement and promissory note and is in breach of contract. Patron sent notification to Mercatus on June 30, 2003, terminating the agreement and requesting Mercatus to return all shares placed in the custodial account with UBS Bank in Switzerland.

Upon receipt of the shares, Patron intends to cancel such shares.

Outside counsel has sent a second demand letter dated May 5, 2003, as the shares have not yet been received. As Mercatus has not returned these shares to the Company's transfer agent by September 25, 2003, the Company intends to take all necessary actions to ensure the prompt return of the shares.

### COMPLETED PRIVATE PLACEMENTS

In March 2003, the Company completed three separate private placements of restricted securities with unaffiliated third parties. A total of 1,162,500 shares were purchased in a range of \$2.00 to \$4.00 per share. Total proceeds were approximately \$2,600,000. These proceeds were used principally as working capital advances to TrustWave Corp. and Entelagent Software Corp., including \$1,000,000 to TrustWave and \$250,000 to Entelagent. The remainder of the proceeds was used for partial repayment of accrued audit and legal fees, as well as reimbursement of shareholder and officer expenses incurred on behalf of the Company. On August 27, 2003, the Company received a letter from the investor who purchased 1,000,000 shares for \$2,000,000 demanding rescission of his investment. It is the view of the Company that there are no grounds for rescission.

On April 4, 2003, Patron completed one private placement of restricted securities with an unaffiliated third party. 125,000 shares were purchased at a price of \$2.00 per share. Total proceeds under this private placement were \$250,000 and were used for partial repayment of accrued Company expenses, as well as reimbursement of shareholder expenses incurred on behalf of the Company. \$50,000 in proceeds were used as a working capital advance to Entelagent Software Corp.

The term sheets for 1,125,000 shares contain a provision for Patron to commit to file a registration statement for these shares within two weeks of the closing of the TrustWave Merger and to use best efforts to ensure that the registration statement is declared effective within ninety days of the closing of the TrustWave Merger.

### FUNDS RECEIVED FROM COMPANY OFFICER

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In March 2003, an officer of the Company (the "officer") borrowed \$635,000 from third parties and used these funds to pay certain legitimate business expenses of the Company. This was done without the knowledge of the CEO and CFO.

Pending determination by Management and the Board as to whether the funds were obtained personally by the officer and deposited in a Company account or whether this officer obtained the funds on behalf of the Company, these transactions and the related funds, as well as the subsequent disbursement of funds to pay liabilities of the Company have been reflected in the financial statements as they occurred inasmuch as the funds were received into and disbursed out of a Company account. The Company's recognizes its obligation to repay the principal due either to the officer or to the third parties.

The funds in the amount of \$635,000 received by the officer were used to reimburse certain creditors and officers of the Company for expenses paid on the Company's behalf, to fund certain expenses of its start up operation in the United Kingdom, and to advance additional funds to Entelagent Software Corp. The remaining cash balance in this account is nominal at June 30, 2003 and the amount has since been closed. Because these transactions were not known by or approved by the CEO or CFO, a breach of the Company's internal controls occurred. Management, the Board and legal counsel are evaluating actions necessary to prevent a similar breach in the future.

15

### NOTE I -- SUBSEQUENT FUNDING EVENT

On September 25, 2003, the Company finalized the terms of a \$50 million private placement of securities consisting of: (i) \$15 million of common stock at a price of \$0.50 per share or 30 million shares, and (ii) \$35 million of convertible preferred stock. The preferred stock has a 5% dividend payable-in-kind and is convertible into common stock at an effective conversion price of \$0.50 per common share. These shares do not have any special registration rights and funding is not dependent on the closing of any specific transaction. In addition, the Company granted to the investors an option for 90 days following the closing of the private placements to invest an additional \$50 million by purchasing up to an additional 100 million shares of common stock at a price of \$0.50 per share. The option period can be extended by mutual agreement. The net proceeds from the private placements, after deducting transactional costs, are expected to be approximately \$49 million (not assuming the optional shares). Patron is negotiating with the investor to lock up all shares for a period of three years. We intend to use the net proceeds for acquisitions and general corporate purposes.

As a condition of this funding process, the Company has agreed to a series of changes, including a significant reduction in the number of founders' shares and management options and reconstituting Patron's management team and Board of Directors. To this end, Rich Linting, Brett Newbold and Marie Meisenbach Graul have resigned from Patron, and Rich Beggs, Warren Luke and Anthony Carbone have left the board of directors. Patron is currently in active discussions with replacement candidates for the board and management team.

### RISK FACTORS

FACTORS THAT MAY AFFECT OUR BUSINESS AND FUTURE RESULTS OF OPERATIONS AND

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### FINANCIAL CONDITION

#### LACK OF PROFITABILITY.

We are at an early stage of executing our business plan and have no history of offering information security capabilities. We have generated no revenue from operations as of June 30, 2003. We have incurred operating and net losses and negative cash flows from operations since our inception. As of June 30, 2003, we had an accumulated deficit of \$16.3 million and net losses of \$3.5 million. We may continue to incur operating and net losses, due in part to implementing our acquisitions strategy, engaging in financing activities and expansion of our personnel and our business development capabilities. We may not be able to achieve or maintain profitability, and, even if we do achieve profitability, the level of any profitability cannot be predicted and may vary significantly from quarter to quarter.

#### LACK OF BUSINESS OPERATIONS.

Patron has generated no revenue from operations to date and relies on revenue generated from our capital raising activities to fund the implementation of our business plan. We will continue to seek financing for the acquisition of Entelagent and other acquisition targets that we may identify in the future. We continue to believe that we will secure financing in the near future, but there can no assurance of our success. If we are unable to obtain the necessary funding, it will materially adversely affect our ability to execute our business plan and to continue our operations.

#### OUR LIMITED HISTORY MAKES IT DIFFICULT TO EVALUATE OUR BUSINESS AND PROSPECTS.

Holdings (as CPS) was incorporated in Nevada in 1995 and Patron was incorporated in Delaware in 2002. We have not had any business operations since inception. As a result of our limited history, it may be difficult to plan operating expenses or forecast our revenues accurately. Our assumptions about customer or network requirements may be wrong. The revenue and income potential of these products is unproven, and the markets addressed by these

16

products are volatile. If such products are not successful, our actual operating results could be below our expectations and the expectations of investors and market analysts, which would likely cause the price of our common stock to decline.

#### LACK OF MARKET FOR PRODUCTS.

We do not have any current products or revenues. We intend to acquire products through the acquisition of existing businesses. There is no guarantee, however, that a market will develop for Internet security solutions of the type we intend to offer. We cannot predict the size of the market for Internet security solutions, the rate at which the market will grow, or whether our target customers will accept our acquired products.

#### THE PRICE OF OUR COMMON STOCK IS LIKELY TO BE VOLATILE.

The market prices of the securities of technology-related companies have historically been volatile and may continue to be volatile. Thus, the market price of our common stock is likely to be subject to wide fluctuations. If our

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revenues do not grow or grow more slowly than we anticipate, if operating or capital expenditures exceed our expectations and cannot be reduced appropriately, or if some other event adversely affects us, the market price of our common stock could decline. Only a small public market currently exists for our common stock and the number of shares eligible for sale in the public market is currently very limited, but is expected to increase. Sales of substantial shares in the future would depress the price of our common stock. In addition, we currently do not receive any stock market research coverage by any recognized stock market research or trading firm and our shares are not traded on any national securities exchange. A larger and more active market for our common stock may not develop.

Because of our limited operations history and lack of assets and revenues to date, our common stock is believed to be currently trading on speculation that we will be successful in implementing our acquisition and growth strategies. There can be no assurance that such success will be achieved. The failure to implement our acquisitions and growth strategies would likely adversely affect the market price of our common stock. In addition, if the market for technology-related stocks or the stock market in general experiences a continued or greater loss in investor confidence or otherwise fails, the market price of our common stock could decline for reasons unrelated to our business, results of operations and financial condition. The market price of our common stock also might decline in reaction to events that affect other companies in our industry even if these events do not directly affect us. General political or economic conditions, such as an outbreak of war, a recession or interest rate or currency rate fluctuations, could also cause the market price of our common stock to decline. Our common stock has experienced, and is likely to continue to experience, these fluctuations in price, regardless of our performance.

THE CONCENTRATION OF OUR CAPITAL STOCK OWNERSHIP WITH INSIDERS IS LIKELY TO LIMIT THE ABILITY OF OTHER STOCKHOLDERS TO INFLUENCE CORPORATE MATTERS.

The executive officers, directors and entities affiliated with any of them together beneficially own approximately 69% of our outstanding common stock. As a result, these stockholders may be able to exercise control over matters requiring approval by our stockholders, including the election of directors and approval of significant corporate transactions. This concentration of ownership might also have the effect of delaying or preventing a change in our control that might be viewed as beneficial by other stockholders.

FUTURE SALES OF SHARES BY EXISTING STOCKHOLDERS COULD CAUSE OUR STOCK PRICE TO DECLINE.

If our existing or future stockholders sell, or are perceived to sell, substantial amounts of our common stock in the public market, the market price of our common stock could decline. As of June 30, 2003, there were approximately 36,426,388 shares of common stock outstanding (which number does not include the 14,592,760 shares of common stock pledged to Mercatus that have been requested to be returned and cancelled, as more fully described in the description of our Liquidity and Capital Resources under the caption "Management's Discussion and Analysis or Plan of Operation"), of which all but 11,026,388 shares will be held by directors, executive officers and other affiliates, the sale of which are subject to volume limitations under Rule 144, various vesting agreements and quarterly and other "blackout" periods. Furthermore, shares subject to outstanding options and warrants and shares

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reserved for future issuance under our stock option plan will become eligible for sale in the public market to the extent permitted by the provisions of various vesting agreements, the lock-up agreements and Rule 144 under the Securities Act.

WE MAY BE UNABLE TO SUCCESSFULLY INTEGRATE.

Our business plan is dependent upon the acquisition and integration of companies that have previously operated independently. The process of integrating could cause an interruption of, or loss of momentum in, the activities of our business and the loss of key personnel. The diversion of management's attention and any delays or difficulties encountered in connection with our integration of acquired operations could have an adverse effect on our business, results of operations, financial condition or prospects.

AVAILABILITY OF FUTURE CAPITAL.

To achieve our intended growth, we will require substantial additional capital. We have encountered difficulty and delays in raising capital to date and the market environment for development stage companies, like Patron, remains particularly challenging. There can be no assurance that funds will be available when needed or on acceptable terms. Technology companies in general have experienced difficulty in recent years in accessing capital. Inability to obtain additional financing may require us to delay, scale back or eliminate certain of our growth plans which could have a material and adverse effect on our business, financial condition or results of operations or to cease operations. Even if we are able to obtain additional financing, such financing could be structured as equity financing that would dilute the ownership percentage of any investor in our securities.

DOWNTURNS IN THE INTERNET INFRASTRUCTURE, NETWORK SECURITY AND RELATED MARKETS MAY DECREASE OUR REVENUES AND MARGINS.

The market for products and other products we intend to offer depends on economic conditions affecting the broader Internet infrastructure, network security and related markets. Downturns in these markets may cause enterprises and carriers to delay or cancel security projects, reduce their overall or security-specific information technology budgets or reduce or cancel orders for products and other products we intend to offer. In this environment, customers such as distributors, value-added resellers and carriers may experience financial difficulty, cease operations and fail to budget or reduce budgets for the purchase of products we intend to offer. This, in turn, may lead to longer sales cycles, delays in purchase decisions, payment and collection, and may also result in price pressures, causing us to realize lower revenues, gross margins and operating margins. In addition, general economic uncertainty caused by potential hostilities involving the United States, terrorist activities, the decline in specific markets such as the service provider market in the United States, and the general decline in the capital spending in the information technology sector make it difficult to predict changes in the purchase and network requirements of our potential customers and the markets we intend to serve. We believe that, in light of these events, some businesses may curtail or eliminate capital spending on information technology. A decline in capital spending in the markets we intend to serve may adversely affect our future revenues, gross margins and operating margins and make it necessary for us to gain significant market share from our future competitors in order to achieve our financial goals and achieve profitability.

COMPETITION MAY DECREASE OUR PROJECTED REVENUES, MARKET SHARE AND MARGINS.

The market for network security products is highly competitive, and we expect competition to intensify in the future. Competitors may gain market share and introduce new competitive products for the same markets and customers we intend



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to serve with our products. These products may have better performance, lower prices and broader acceptance than the products we intend to offer.

Many of our potential competitors have longer operating histories, greater name recognition, large customer bases and significantly greater financial, technical, sales, marketing and other resources than we will have. In addition, some of our potential competitors currently combine their products with other companies' networking and security products. These potential competitors also often combine their sales and marketing efforts. Such activities may result in reduced prices, lower gross and operating margins and longer sales cycles for the products we intend to offer. If any of our larger potential competitors were to commit greater technical, sales, marketing and other resources to the markets we intend to serve, or reduce prices for their products over a sustained period of time, our

18

ability to successfully sell the products we intend to offer, increase revenue or meet our or market analysts' expectations could be adversely affected.

FAILURE TO ADDRESS EVOLVING STANDARDS IN THE NETWORK SECURITY INDUSTRY AND SUCCESSFULLY DEVELOP AND INTRODUCE NEW PRODUCTS OR PRODUCT ENHANCEMENTS WOULD CAUSE OUR REVENUES TO DECLINE.

The market for network security products is characterized by rapid technological change, frequent new product introductions, changes in customer requirements and evolving industry standards. We expect to introduce our products and enhancements to existing products to address current and evolving customer requirements and broader networking trends and vulnerabilities. We also expect to develop products with strategic partners and incorporate third-party advanced security capabilities into our intended product offerings. Some of these products and enhancements may require us to develop new hardware architectures and ASICs that involve complex and time consuming processes. In developing and introducing our intended product offerings, we have made, and will continue to make, assumptions with respect to which features, security standards and performance criteria will be required by our potential customers. If we implement features, security standards and performance criteria that are different from those required by our potential customers, market acceptance of our intended product offerings may be significantly reduced or delayed, which would harm our ability to penetrate existing or new markets.

Furthermore, we may not be able to develop new products or product enhancements in a timely manner, or at all. Any failure to develop or introduce these new products and product enhancements may adversely affect our ability to sell solutions to address large customer deployments and, as a consequence, our revenues may be adversely affected. In addition, the introduction of products embodying new technologies could render existing products we intend to offer obsolete, which would have a direct, adverse effect on our market share and revenues. Any failure of our future products or product enhancements to achieve market acceptance could cause our revenues to decline and our operating results to be below our expectations and the expectations of investors and market analysts, which would likely cause the price of our common stock to decline.

THE UNPREDICTABILITY OF AN ACQUIRED COMPANY'S QUARTERLY RESULTS MAY CAUSE THE TRADING PRICE OF OUR COMMON STOCK TO DECLINE.

The quarterly revenues and operating results of companies we may acquire will likely continue to vary in the future due to a number of factors, many of which

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are outside of our control. Any of these factors could cause the price of our common stock to decline. The primary factors that may affect future revenues and future operating results include the following:

- the demand for intended current product offerings and our future products;
- the length of sales cycles;
- the timing of recognizing revenues;
- new product introductions by us or our competitors;
- changes in our pricing policies or the pricing policies of our competitors;
- variations in sales channels, product costs or mix of products sold;
- our ability to develop, introduce and ship in a timely manner new products and product enhancements that meet customer requirements;
- our ability to obtain sufficient supplies of sole or limited source components, including ASICs, and power supplies, for our products;
- variations in the prices of the components we purchase;
- our ability to attain and maintain production volumes and quality levels for our products at reasonable prices at our third-party manufacturers;
- our ability to manage our customer base and credit risk and to collect accounts receivable; and
- the financial strength of our value-added resellers and distributors.

Our operating expenses are largely based on anticipated revenues and a high percentage of our expenses are, and will continue to be, fixed in the short term. As a result, lower than anticipated revenues for any reason could cause significant variations in our operating results from quarter to quarter and, because of our rapidly growing operating

19

expenses, could result in substantial operating losses. In this event, the price of our common stock would likely decline.

WE MAY EXPERIENCE ISSUES WITH OUR FINANCIAL SYSTEMS, CONTROLS AND OPERATIONS THAT COULD HARM OUR FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

Our ability to sell our intended product offerings and implement our business plan successfully in a volatile and growing market requires effective management and financial systems and a system of financial processes and controls. We have limited management resources today and are still establishing our management and financial systems. Growth, to the extent it occurs, is likely to place a considerable strain on our management resources, systems, processes and controls. To address these issues, we will need to continue to improve our financial and managerial controls, reporting systems and procedures, and will need to continue to expand, train and manage our work force worldwide. If we are unable to maintain an adequate level of financial processes and controls, we may not be able to accurately report our financial performance on a timely basis and our business and stock price would be harmed.

IF OUR FUTURE PRODUCTS DO NOT INTEROPERATE WITH OUR END CUSTOMERS' NETWORKS, INSTALLATIONS WOULD BE DELAYED OR CANCELLED, WHICH COULD SIGNIFICANTLY REDUCE OUR ANTICIPATED REVENUES.

Future products will be designed to interface with our end customers' existing

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networks, each of which have different specifications and utilize multiple protocol standards. Many end customers' networks contain multiple generations of products that have been added over time as these networks have grown and evolved. Our future products must interoperate with all of the products within these networks as well as with future products that might be added to these networks in order to meet end customers' requirements. If we find errors in the existing software used in our end customers' networks, we may elect to modify our software to fix or overcome these errors so that our products will interoperate and scale with their existing software and hardware. If our future products do not interoperate with those within our end customers' networks, installations could be delayed or orders for our products could be cancelled, which could significantly reduce our anticipated revenues.

WE WILL DEPEND ON OUR KEY PERSONNEL TO MANAGE OUR BUSINESS EFFECTIVELY IN A RAPIDLY CHANGING MARKET, AND IF WE ARE UNABLE TO HIRE ADDITIONAL PERSONNEL OR RETAIN EXISTING PERSONNEL, OUR ABILITY TO EXECUTE OUR BUSINESS STRATEGY WOULD BE IMPAIRED.

We currently have only two employees. Our future success depends upon the continued services of our executive officers., The loss of the services of any of our key employees, the inability to attract or retain qualified personnel in the future, or delays in hiring required personnel, could delay the development and introduction of, and negatively impact our ability to sell, our intended product offerings.

WE MIGHT HAVE TO DEFEND LAWSUITS OR PAY DAMAGES IN CONNECTION WITH ANY ALLEGED OR ACTUAL FAILURE OF OUR PRODUCTS AND SERVICES.

Because our intended product offerings and services provide and monitor network security and may protect valuable information, we could face claims for product liability, tort or breach of warranty. Anyone who circumvents our security measures could misappropriate the confidential information or other property of end customers using our products, or interrupt their operations. If that happens, affected end customers or others may sue us. Defending a lawsuit, regardless of its merit, could be costly and could divert management attention. Our business liability insurance coverage may be inadequate or future coverage may be unavailable on acceptable terms or at all.

WE COULD BECOME SUBJECT TO LITIGATION REGARDING INTELLECTUAL PROPERTY RIGHTS THAT COULD BE COSTLY AND RESULT IN THE LOSS OF SIGNIFICANT RIGHTS.

In recent years, there has been significant litigation in the United States involving patents and other intellectual property rights. We may become a party to litigation in the future to protect our intellectual property or as a result of an alleged infringement of another party's intellectual property. Claims for alleged infringement and any resulting

20

lawsuit, if successful, could subject us to significant liability for damages and invalidation of our proprietary rights. These lawsuits, regardless of their success, would likely be time-consuming and expensive to resolve and would divert management time and attention. Any potential intellectual property litigation could also force us to do one or more of the following:

- stop or delay selling, incorporating or using products that use the challenged intellectual property;
- obtain from the owner of the infringed intellectual property right

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- a license to sell or use the relevant technology, which license might not be available on reasonable terms or at all; or
- redesign the products that use that technology.

If we are forced to take any of these actions, our business might be seriously harmed. Our insurance may not cover potential claims of this type or may not be adequate to indemnify us for all liability that could be imposed.

THE INABILITY TO OBTAIN ANY THIRD-PARTY LICENSE REQUIRED TO DEVELOP NEW PRODUCTS AND PRODUCT ENHANCEMENTS COULD REQUIRE US TO OBTAIN SUBSTITUTE TECHNOLOGY OF LOWER QUALITY OR PERFORMANCE STANDARDS OR AT GREATER COST, WHICH COULD SERIOUSLY HARM OUR BUSINESS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

From time to time, we may be required to license technology from third parties to develop new products or product enhancements. Third-party licenses may not be available to us on commercially reasonable terms or at all. The inability to obtain any third-party license required to develop new products or product enhancements could require us to obtain substitute technology of lower quality or performance standards or at greater cost, which could seriously harm our business, financial condition and results of operations.

GOVERNMENTAL REGULATIONS AFFECTING THE IMPORT OR EXPORT OF PRODUCTS COULD NEGATIVELY AFFECT OUR REVENUES.

Governmental regulation of imports or exports or failure to obtain required export approval of encryption technologies we intend to acquire could harm our international and domestic sales. The United States and various foreign governments have imposed controls, export license requirements and restrictions on the import or export of some technologies, especially encryption technology. In addition, from time to time, governmental agencies have proposed additional regulation of encryption technology, such as requiring the escrow and governmental recovery of private encryption keys.

In particular, in light of recent terrorist activity, governments could enact additional regulation or restrictions on the use, import or export of encryption technology. Additional regulation of encryption technology could delay or prevent the acceptance and use of encryption products and public networks for secure communications. This might decrease demand for our intended product offerings and services. In addition, some foreign competitors are subject to less stringent controls on exporting their encryption technologies. As a result, they may be able to compete more effectively than we can in the domestic and international network security market.

MANAGEMENT COULD INVEST OR SPEND OUR CASH OR CASH EQUIVALENTS AND INVESTMENTS IN WAYS THAT MIGHT NOT ENHANCE OUR RESULTS OF OPERATIONS OR MARKET SHARE.

We have made no specific allocations of our cash or cash equivalents and investments. Consequently, management will retain a significant amount of discretion over the application of our cash or cash equivalents and investments and could spend the proceeds in ways that do not improve our operating results or increase our market share. In addition, these proceeds may not be invested to yield a favorable rate of return.

### ITEM 3. CONTROLS AND PROCEDURES.

Under the supervision and with the participation of Patron's management, including Patron's Chief Executive Officer (CEO) and Chief Financial Officer (CFO), Patron has evaluated the effectiveness of the design and operation of its disclosure controls and procedures pursuant to Exchange Act Rule 13a-14(c) within 90 days of the filing date of this quarterly report. Subsequent to the initial filing of the Company's Form 10-QSB as of and for the period ended March 31, 2003 and prior to the filing of a Form 10-QSB/A for the period ended March

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31, 2003, the Company's CEO and CFO became aware of March 2003 transactions disclosed elsewhere in this filing which occurred in a cash account of the Company involving the deposit of funds into the account by an officer of the Company and the payment of Company liabilities using those funds. Because these transactions were not known by or approved by the CEO or CFO, a breach of the Company's internal controls occurred. Management has since closed the cash account and with legal counsel are evaluating actions necessary to prevent a similar breach in the future. In addition, even though the previously unrecorded transactions did not have a material affect on the reported net loss of the Company for the quarter ended March 31, 2003, an amended Form 10QSB/A reflecting such transactions has been filed with the Securities and Exchange Commission. Based on that evaluation, except for the aforementioned breach of internal controls, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures are effective. Other than the actions being taken to remedy the breach of internal controls disclosed above, there were no significant changes in Patron's internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation.

21

### PART II -- OTHER INFORMATION

#### ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

##### (a) Exhibits.

- 31.1 Certification pursuant to Rule 13(a) -- 15(e) or Rule 15(d) -- 15(e), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 -- Chief Executive Officer-Patron Systems, Inc.
- 31.2 Certification pursuant to Rule 13(a) -- 15(e) or Rule 15(d) -- 15(e), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 -- Chief Financial Officer -- Patron Systems, Ic.
- 32.1 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 -- Chief Executive Officer -- Patron Systems, Inc.
- 32.2 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 -- Chief Financial Officer -- Patron Systems, Inc.

##### (b) Reports on Form 8-K.

On January 16, 2003, we filed a current report on Form 8-K with the Securities and Exchange Commission containing two press release issued on January 2, 2003 and January 15, 2003, announcing the appointment of Richard G. Beggs, Warren K. Luke and Robert E. Yaw II to serve on the Board of Directors, and an increase in the size of the Board to nine.

On January 16, 2003, we filed a current report on Form 8-K with the Securities and Exchange Commission containing a press release issued on January 15, 2003 announcing the execution of a term sheet with a private group of international

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investors for an investment facility to Patron.

On January 28, 2003, we filed a current report on Form 8-K with the Securities and Exchange Commission containing a press release issued on January 22, 2003 announcing the execution of a memorandum of understanding with TELSECURE (UK) LTD, for the development by Patron of an information security platform and broad-based suite of security products to support TELSECURE's wireless business application development project, and a press release issued on January 24, 2003 announcing the progress of business combinations with TrustWave Corp. and with Entelagent Software Corp.

On March 27, 2003, we filed a current report on Form 8-K with the Securities and Exchange Commission announcing the consummation of the merger of Patron Holdings, Inc., a Nevada corporation, with and into Patron Systems, Inc.

ITEMS 1 THROUGH 5 ARE NOT APPLICABLE AND HAVE BEEN OMITTED.

22

SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PATRON SYSTEMS, INC.

Date: September 25, 2003

/s/ Patrick J. Allin

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Patrick J. Allin  
Chief Executive Officer and  
Acting Chief Financial Officer