

SOUTHWALL TECHNOLOGIES INC /DE/
Form PRER14A
July 20, 2004
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

SCHEDULE 14A

Proxy Statement Pursuant to Section 14(a) of the Securities
Exchange Act of 1934 (Amendment No. 2)

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SOUTHWALL TECHNOLOGIES INC.

(Name of Registrant as Specified In Its Charter)

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SOUTHWALL TECHNOLOGIES INC.

**3975 East Bayshore Road
Palo Alto, California 94303**

, 2004

Dear Stockholder:

On February 24, 2004, we announced that we had entered into an agreement with Needham & Company, Inc., a U.S. investment banking, securities and asset management firm, certain of its affiliates and Dolphin Asset Management, a New York-based asset management firm. The agreement amended and restated an agreement entered into among the parties on December 18, 2003. Pursuant to the original agreement and the amended and restated agreement, we consummated a series of related transactions resulting in:

- the issuance and sale to Needham, its affiliates and Dolphin of convertible notes in an aggregate principal amount of \$4,500,000, which are convertible into shares of our series A convertible preferred stock at a conversion price of \$1.00 per share and are secured by a pledge of shares of a portion of the shares of our German subsidiary;
- the establishment of a revolving line of credit with Pacific Business Funding, or PBF, providing for borrowing availability up to \$3,000,000, guaranteed by Needham;
- in connection with the establishment of the revolving line of credit and the agreement to forbear from exercising remedies in connection with defaults under other credit agreements between us and PBF, the issuance to PBF of warrants exercisable for an aggregate of 360,000 shares (subject to adjustment) of the our common stock, at an exercise price per share equal to \$.01; and
- the issuance to Needham, its affiliates and Dolphin of warrants exercisable for up to 13,881,536 shares (subject to adjustment) of the our common stock, at an exercise price per share equal to \$.01, in connection with the issuance of the convertible notes, in consideration of Needham's guarantee, and pursuant to anti-dilution provisions triggered by our arrangements with our creditors.

We undertook these transactions to address our urgent need to raise additional cash, and, without them, we believe we would have been required to file for bankruptcy. We believe that these transactions will provide us with additional time in seeking to achieve production qualification for new products for the electronic display market and may assist us in seeking to achieve quarterly cash break-even by the end of 2004.

Accordingly, I am pleased to invite you to attend an annual meeting of stockholders on _____, 2004 at 9:00 a.m., at our principal executive offices at 3975 East Bayshore Road, Palo Alto, California, to consider an amendment of our charter to increase the number of shares of capital stock we have authorized for issuance in order to allow us to be able to fulfill our contractual obligations and issue all of the shares of common stock issuable in the event of conversion the convertible notes and exercise of the warrants that we issued in connection with the transactions described above, as well as other future equity issuances, including those pursuant to our equity compensation plans. If the charter amendment is not approved, we will not have a sufficient number of shares of common stock available to meet all of our possible obligations to issue shares of common stock and could be subject to legal action by the holders of these rights, and we will be required to repay the entire principal amount of \$4,500,000 under the convertible notes plus interest to the holders of the notes 45 days following the annual meeting.

In addition, we will seek stockholder approval to amend our 1997 Stock Incentive Plan and to approve our 1998 Stock Plan for Employees and Consultants, as amended. We are proposing to amend these plans to increase the number of shares available for issuance from 2,150,000 to 6,150,000 in the case of the 1997 plan and from 1,150,000 to 2,400,000 in the case of the 1998 plan, and to make certain other changes to

these plans, including to eliminate the evergreen provisions that automatically on the first day of each year have increased the number of shares available for issuance under the plans. We believe the amendments to the plans will help us to restore the competitiveness of our compensation programs. We view the amendments to the plans as critical to our ability to attract, motivate and retain the types of key employees and non-employee directors who are essential to our growth and success.

After careful review, the Board of Directors has unanimously determined that the increase in the number of authorized shares of our capital stock, as well as the other matters for which we are seeking approval at the annual meeting, are in the best interests of Southwall Technologies and its stockholders. Therefore, the Board recommends that you vote to approve each of the proposals to be considered at the annual meeting.

As a stockholder, you have the opportunity to voice your opinion on the proposals. Your vote is important. **Even if you plan to attend the annual meeting, please be sure to complete, sign and return the proxy card in the enclosed, postage-prepaid envelope as promptly as practicable.** You may revoke your proxy at any time before it is exercised at the annual meeting or vote your shares personally if you attend the annual meeting.

Attached are a Notice of Annual Meeting of Stockholders and a Proxy Statement containing a discussion of the proposals. We urge you to read this material carefully.

Thank you in advance for your participation and prompt attention.

/s/ THOMAS G. HOOD

Sincerely,
Thomas G. Hood
President and Chief Executive Officer

SOUTHWALL TECHNOLOGIES INC.

3975 East Bayshore Road
Palo Alto, California 94303

NOTICE OF ANNUAL MEETING OF STOCKHOLDERS

To Be Held on _____, 2004

To the stockholders of Southwall Technologies Inc.:

The Board of Directors of Southwall Technologies Inc. has called a annual meeting to seek stockholder approval of a proposed amendment to Southwall's charter and other matters listed below.

Each of the matters submitted to our stockholders at the annual meeting is described in more detail in the accompanying proxy statement. We encourage you to read the proxy statement, including the appendixes, in its entirety. The details of the annual meeting are as follows:

Date: _____, 2004
Time: 9:00 a.m., local time
Place: Our principal executive offices at 3975 East Bayshore Road, Palo Alto, California
Items of Business: At the annual meeting, you and our other stockholders will be asked to:

1. elect directors to serve for the ensuing year;
2. approve an amendment to our certificate of incorporation to increase:
 - the number of authorized shares of common stock from 20,000,000 to 50,000,000, and
 - the total number of authorized shares of capital stock from 25,000,000 to 55,000,000;

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3. approve an amendment to our 1997 Stock Incentive Plan;
4. approve our 1998 Stock Plan for Employees and Consultants, as amended; and
5. transact such other business as may properly come before the meeting or any adjournment.

Record Date: You may vote at the annual meeting if you were a stockholder of record at the close of business on June 30, 2004.

Proxy Voting: Your vote is important. You may vote on these matters in person or by proxy. We ask that you complete and return the enclosed proxy card promptly-whether or not you plan to attend the annual meeting-in the enclosed addressed, postage-paid envelope, so that your shares will be represented and voted at the annual meeting in accordance with your wishes. You can revoke your proxy at any time prior to its exercise by written notice received by us, by delivering to us a duly executed proxy bearing a later date, or by attending the annual meeting and voting your shares in person.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of the transactions described in this document, passed upon the fairness or merits of these transactions, or passed upon the accuracy or adequacy of the disclosure in this document. Any representation to the contrary is a criminal offense.

This notice, the attached proxy statement and form of proxy card are first being mailed to our stockholders beginning on or about , 2004.

/s/ MAURY AUSTIN

By Order of the Board of Directors

Maury Austin
Secretary

Palo Alto, California
, 2004

If you have any questions about the proposals, including the procedures for voting your shares, please contact Maury Austin at (650) 962-9111.

**PROXY STATEMENT
FOR
ANNUAL MEETING OF STOCKHOLDERS
TO BE HELD ON , 2004**

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PROXY STATEMENT SUMMARY

We have included the following summary of our recent financing transaction that gives rise to the need to increase the number of shares of our authorized common stock and related matters to provide background information about the proposals to be presented at the annual meeting. You are encouraged to read this entire proxy statement, including the appendixes. This summary is qualified in its entirety by the full text of this proxy statement, including the appendixes.

Annual Meeting *(see discussion beginning at page 7)*

We have sent you this proxy statement and the enclosed proxy card because our Board of Directors is soliciting your proxy to vote at our annual meeting of stockholders or any adjournment or postponement of the annual meeting. The annual meeting will be held at 9:00 a.m., local time, on June 30, 2004, at our principal executive offices located at 3975 East Bayshore Road, Palo Alto, California. You may vote at the annual meeting if you were a stockholder of record at the close of business on June 30, 2004, the record date for the annual meeting.

Background of Financing *(see discussion beginning at page 17)*

During 2003, we experienced a significant decline in sales, which led to a significant deterioration in our working capital position, which raised concerns about our ability to fund our operations, continue as a going concern and meet our obligations.

On October 8, 2003, our management reviewed the revenue forecast for the fourth quarter of 2003 and determined that the anticipated sales for the quarter would not generate enough cash flow to continue operations through the end of the quarter. Management presented its findings to our

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Board of Directors on October 10, 2003, and the directors instructed our management team to develop an emergency restructuring plan to improve our cash flow and to obtain new financing.

The primary elements of management's restructuring plan included:

- Shutting down a majority of our domestic manufacturing and transferring that production to our Dresden, Germany facility;
- Undertaking a series of staggered layoffs;
- Arranging new payment terms with major creditors and vendors to extend or reduce our payment obligations;
- Accelerating our cash collections;
- Reducing our operating expenses and inventory levels;
- Minimizing our capital expenditures; and
- Seeking new sources of financing.

We also began to solicit and receive proposals from potential investors and lenders. We evaluated a variety of alternatives to raise additional capital, as well as alternatives to restructure our upcoming payment obligations without raising additional capital. Our access to the traditional capital markets was, and continues to be, constrained, however, by a number of factors, including our financial position and results of operations, as well as the risks described in our filings with the SEC. As a result, we concluded that a private equity investment was the most attractive alternative to continue as a going concern.

We received and evaluated three financing proposals, including the Needham & Company, Inc., or Needham, proposal, which is described in further detail below. One proposal consisted of an initial offer to purchase up to \$3.0 million of our common stock, in two tranches, at a price equal to 70% of the average

closing price of our common stock on the Nasdaq National Market during the 10 days preceding the closing dates. The initial tranches would have consisted of \$2.0 million of our common stock, with the additional \$1.0 million of common stock to have been purchased at the option of the investor within 18 months of the closing of the initial tranche. In addition, the investor would have received warrants for approximately 6,000,000 shares of our common stock, exercisable for five years at a per share exercise price equal to 110% of the closing price of our common stock on the Nasdaq National Market as of the business day prior the closing of the initial equity tranche. Another proposal contemplated the issuance of a \$2.0 million letter of credit to Pacific Business Funding, or PBF, against which we would have been able to borrow under our existing domestic factoring agreement with PBF.

After reviewing and seeking to negotiate revisions to all of the proposals submitted, the Board unanimously determined on November 10, 2003 to proceed with the Needham offer, primarily because the Board believed that the amount of cash that we would have received under each of the two other proposals would have been insufficient to meet our short-term operational cash flow requirements.

Summary of the Financing (*see discussion beginning on page 17*)

On December 18, 2003, to raise cash to fund our operations and continue as a going concern, we entered into an investment agreement with Needham & Company, Inc., Needham Capital Partners II, L.P., Needham Capital Partners II (Bermuda), L.P., Needham Capital Partners III, L.P., Needham Capital Partners IIIA, L.P., Needham Capital Partners III (Bermuda), L.P., and Dolphin Direct Equity Partners, LP, collectively the Investors. Under the terms of the investment agreement, Needham & Company, Inc. agreed to issue guarantees of our new line of credit facility in two separate tranches of \$2.25 million and \$750,000, respectively, and the Investors agreed to purchase shares of our Series A 10% Cumulative Convertible Preferred Stock, par value \$.001 per share, or the Series A shares, in two separate tranches of \$1.5 million and \$3.0 million, respectively. The new borrowings and the purchase of each equity tranche were subject to certain conditions, including, among other things, the receipt of concessions by us from creditors and landlords, the completion by us of certain restructuring actions and the achievement of cash flow break-even. Needham executed a guarantee of up to \$2.25 million of our indebtedness under the new line of credit facility on December 18, 2003, and received a warrant to purchase 941,115 shares of our common stock, approximately 7.5% of our total shares currently outstanding. On January 15, 2004, Needham increased its guarantee of our obligations under the new line of credit by \$750,000 and received an additional warrant to purchase 941,115 shares of common stock. A further description of the terms of all warrants is set forth below.

On February 20, 2004, the parties amended and restated the investment agreement to provide that we would issue and sell to the Investors an aggregate of \$4.5 million of our convertible notes in one tranche instead of Series A shares in two separate tranches. A further description of the convertible notes is set forth below. In connection with the sale of the convertible notes, on February 20, 2004, we issued warrants to the Investors to purchase a total of 1,694,007 shares of our common stock, approximately 13.5% of our total shares currently outstanding. Under the investment agreement, and as further described in the Anti-Dilution Protection section below, we were also required to issue warrants to the Investors for an additional 10,305,299 shares of our common stock, approximately 82.1% of our total shares currently outstanding, pursuant to anti-dilution provisions in the investment agreement that were triggered by the issuance of debt and equity by us as part of the restructuring of our obligations to creditors.

Reasons for the Financing (*see discussion on page 20*)

In the short-term, the financing is intended to enable us to fund our operations, continue as a going concern and meet our financial obligations, as they become due. In addition, the financing will strengthen our balance sheet by increasing our liquidity and working capital.

The net proceeds from the financing, after payment of expenses associated with the financing, have been and will be used to settle payment disputes with and restructure some of our obligations to creditors, purchase raw materials and pay salaries and rent.

Summary of Current Ownership by Investors (*see discussion on page 19*)

Following completion of the financing, based on securities outstanding as of March 28, 2004, the following convertible securities and warrants are held by the Investors:

- if Needham and its affiliated entities were to exercise all of their warrants and convert all of their Series A shares (issuable upon conversion of their convertible notes), while maintaining their current ownership of approximately 2,200,067 shares of common stock, then Needham and its affiliated entities would own approximately 15,081,834 shares of our common stock, or about 59.3% of the total shares outstanding, including such issuances to Needham and its affiliates but excluding outstanding warrants and Series A shares held by other Investors; and
- if Dolphin Direct Equity Partners, LP were to exercise all warrants and convert all of its Series A shares (issuable upon conversion of its convertible notes), then Dolphin would own approximately 5,499,769 shares of our common stock, or about 30.5% of the total shares outstanding, including such issuances to Dolphin but excluding outstanding warrants and Series A shares held by other Investors.

In addition, the convertible notes held by the Investors accrue interest 10% per year, compounded daily, payable each December 31st, which interest is also convertible into Series A shares, and the Series A shares are entitled to a cumulative dividend of 10% per year, accruing daily, payable at the discretion of the Board, which dividends are convertible into common stock.

Material Terms of the Convertible Notes (*see discussion beginning on page 21*)

In connection with the investment agreement, we issued convertible notes in an aggregate principal amount of \$4.5 million to the Investors. The convertible notes:

- are convertible, at each holder's option, into our Series A shares at a conversion price of \$1.00 per share (subject to adjustment);
- accrue interest at an annual rate of 10%, compounded daily, payable each December 31, which interest if accrued but unpaid is also convertible into Series A shares;
- are secured by a pledge of a portion of the stock of our subsidiary, Southwall Europe GmbH; and
- are due and payable on February 20, 2009 or earlier under certain circumstances. For instance, the failure of our stockholders to approve Proposal 2 (the amendment of our charter) will result in the acceleration of the convertible notes.

In addition, so long as any of the convertible notes are outstanding, the approval of the holders of a majority of the convertible notes will be required to effect certain corporate actions. The convertible notes are subordinate to the credit facilities with our senior lender, PBF.

Material Terms of the Series A Convertible Preferred Stock (*see discussion beginning on page 22*)

Dividends on Series A Shares. Each of the Series A shares will have a stated value of \$1.00 and will be entitled to a cumulative dividend of 10% per year, payable at the discretion of the Board of Directors. Dividends on the Series A shares shall accrue daily commencing on the date of issuance and shall be deemed to accrue whether or not earned or declared and whether or not there are profits, surplus or other funds legally available for the payment of dividends. Accumulated dividends, when and if declared by the Board, will be paid in cash.

Restrictions. So long as any Series A shares are outstanding, unless all accrued dividends on all Series A shares have been paid, we are generally prohibited from redeeming or purchasing (or setting aside any monies for the redemption or purchase of) any capital stock ranking junior to the Series A shares in respect of dividends or liquidation preference and paying or declaring any cash dividend or making any cash distribution upon any capital stock ranking junior to the Series A shares in respect of dividends or liquidation preference.

General Voting Rights. Except as described below or as otherwise provided by law, the holders of Series A shares have no voting rights. The approval of the holders of a majority of the Series A shares voting separately as a class will be required to effect certain corporate actions, including the authorization or issuance of shares having preferences or priorities superior to or on a parity with any rights of the Series A shares; the reclassification of any shares into shares having preferences or priorities superior to or on a parity with any rights of the Series A shares; the authorization or issuance of any obligations convertible into or exchangeable for any shares having preferences or priorities superior to or on a parity with any rights of the Series A shares; declaring or paying dividends on or making any distributions with respect to our common stock; increasing or decreasing the authorized number of Series A shares; amending our certificate of incorporation or bylaws to alter or change the preferences, rights, privileges or powers of, or the restrictions provided for the benefit of, any Series A shares; increasing the number of shares of common stock reserved for issuance under our stock option plans; engaging in any transaction constituting a liquidation or dissolution of Southwall, the sale of all or substantially all of our assets, or the acquisition of Southwall by another entity; or making any material change to our line of business.

Liquidation Preference. Upon a liquidation or dissolution of Southwall, the holders of Series A shares are entitled to be paid a liquidation preference out of assets legally available for distribution to our stockholders before any payment may be made to the holders of common stock. The liquidation preference is equal to the stated value of the Series A shares, which is \$1.00 per share, plus any accumulated but unpaid dividends. Mergers, the sale of all or substantially all of our assets, or the acquisition of Southwall by another entity and certain other similar transactions may be deemed to be liquidation events for these purposes.

Conversion. Each of the Series A shares is convertible into common stock at any time at the option of the holder. Each of the Series A shares is convertible into a number of shares of common stock equal to the sum of its stated value plus any accumulated but unpaid dividends, divided by the conversion price of the Series A shares. The conversion price of the Series A shares is \$1.00 per share and is subject to adjustment in the event of any stock dividend, stock split, reverse stock split or combination affecting such shares. The Series A shares also have anti-dilution protection that adjusts the conversion price downwards using a weighted-average calculation in the event we issue certain additional securities at a price per share less than the closing price per share of our common stock on the Nasdaq National Market or any other stock exchange on which our common stock is listed. Each Series A share is initially convertible into one share of common stock.

If the closing price of our common stock on the Nasdaq National Market or any other stock exchange on which our common stock is listed is \$4.00 or more per share (subject to appropriate adjustment if a stock split, reverse split or similar transaction is effected) for 30 consecutive days, all outstanding Series A shares shall automatically be converted into common stock.

Redemption. The Series A shares are not redeemable.

Material Terms of the Warrants (see discussion beginning on page 24)

Investor Warrants. In connection with the investment agreement, we issued warrants (including warrants issued to the Investors as anti-dilution protection for the issuance of debt and equity by us as part of the restructuring of our obligations to creditors) to the Investors that may be exercised to acquire up to

13,881,536 shares of common stock at an initial exercise price of \$0.01 per share. The number of shares and the exercise price are subject to appropriate adjustment in the event of stock splits, reverse stock splits and the granting of a stock dividend on our outstanding common stock. These warrants will be exercisable for cash or through a cashless exercise feature. The warrants are exercisable immediately and have a term of approximately five years.

Upon the reclassification of our common stock or a capital reorganization, each holder of these warrants has the right to receive the same amount and kind of securities, cash or property upon exercise as it would have been entitled to receive had it been the owner of the shares of common stock underlying the warrants at the time of such transaction. Upon a merger or consolidation, a transfer of all or substantially all of our voting securities, or the sale of all or substantially all of our assets, the warrants will terminate if they have not been previously exercised. The holders of the warrants have registration rights under the registration rights agreement described below.

PBF Warrants. In connection with the credit facilities with our senior lender, PBF, we issued warrants to PBF that may be exercised to acquire up to 360,000 shares of common stock at an initial exercise price of \$0.01 per share. The terms of these warrants are generally the same as the terms of the warrants issued to the Investors.

Other Proposals *(see discussions beginning on pages 13, 28 and 35)*

In addition to soliciting stockholder approval of the proposed amendment to our charter to increase our authorized shares, our Board of Directors is requesting approval of several other proposals.

We propose to have the stockholders approve amendments to our 1997 Stock Incentive Plan and our 1998 Stock Plan for Employees and Consultants, as amended. We believe that our future success depends significantly on our ability to provide incentives to new and existing employees and to outside directors in the form of equity grants. To attract, retain and motivate employees, Board members and consultants, it is important for us to be able to provide appropriate periodic equity incentives, especially in light of our recent financial difficulties and related restructurings. Although we have over 3,000,000 options currently outstanding, all of them have exercise prices that are in excess (and in many cases significantly in excess) of the recent trading prices of our common stock, and, therefore, we believe that those outstanding options do not provide the incentive that new options priced at current market prices would. Stockholder approval of the amendments to the 1997 Plan and of the 1998 Plan, as amended, will allow us to continue to make these periodic grants. In addition, the amendments to the plans would eliminate the evergreen provisions that automatically on the first day of each year increase the number of shares available for issuance under the plans.

Voluntary Delisting from Nasdaq *(see discussion beginning on page 27)*

Effective March 26, 2004, we voluntarily de-listed from the Nasdaq National Market, and, after trading on the pink sheets, on May 6, 2004, we began trading on the Over-the-Counter Bulletin Board market. Due to the structure of the transaction contemplated by the investment agreement, we were no longer in compliance with certain Nasdaq listing requirements. We felt that a voluntary delisting from Nasdaq and a move to the Over-the-Counter Bulletin Board Market would provide the best option to our shareholders by retaining liquidity in our common stock.

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**CAUTIONARY STATEMENT CONCERNING
FORWARD-LOOKING INFORMATION**

This proxy statement and the documents to which we refer you and incorporate into this proxy statement by reference contain forward-looking statements. In addition, from time to time we or our representatives may make forward-looking statements orally or in writing. We base these forward-looking statements on our expectations and projections about future events, which we derive from the information currently available to us. Such forward-looking statements relate to future events or future performance.

Forward-looking statements are statements that are not historical in nature and include those that use the words may, will, should, expects, anticipates, contemplates, estimates, believes, plans, projected, predicts, potential or continue or the negative of these or similar words. When evaluating these forward-looking statements, you should consider various factors, including the competitive environment of our business and the performance of financial markets and general economic conditions. These and other factors, including those contained in our public filings, may cause actual results and events to differ materially from any forward-looking statement. The forward-looking statements represent our estimates as of the date on which we filed this proxy statement with the Securities and Exchange Commission, or the SEC.

Forward-looking statements are only predictions and by their nature are subject to risks, uncertainties and assumptions. The forward-looking events discussed in this proxy statement, the documents to which we refer you and incorporate by reference into this proxy statement and other statements made from time to time by us or our representatives may not occur, and actual events and results may differ materially. Accordingly, you are cautioned not to place undue reliance on any forward-looking statements. Moreover, we assume no obligation to update these forward-looking statements to reflect actual results, changes in assumptions or changes in other factors that might affect the forward-looking statements.

QUESTIONS AND ANSWERS ABOUT THE ANNUAL MEETING

We have included the following discussion of the matters to be presented at the annual meeting to provide summary answers to some of the questions that you might have about the annual meeting and the proposals to be presented to our stockholders at the annual meeting. You are encouraged to read the entire proxy statement, including the appendixes. The information below is qualified in its entirety by the full text of this proxy statement and the attached appendixes.

About the Annual Meeting

Q. Why did Southwall send me this proxy statement?

A. We have sent you this proxy statement and the enclosed proxy card because our Board of Directors is soliciting your proxy to vote at the annual meeting, including any adjournment or postponement of the annual meeting. The annual meeting will be held at 9:00 a.m., local time, on _____, _____, 2004, at our principal executive offices located at 3975 East Bayshore Road, Palo Alto, California.

- This PROXY STATEMENT summarizes information about the proposals to be considered at the annual meeting and other information you may find useful in determining how to vote.
- The PROXY CARD is the means by which you actually authorize the persons named in the proxy card to vote your shares in accordance with your instructions.

We are mailing this proxy statement and the enclosed proxy card to stockholders for the first time on or about _____, 2004.

Q. What is a proxy and how does it work?

A. We are asking for your proxy. Giving your proxy means that you authorize the persons named in the proxy to vote your shares at the annual meeting in the manner that you direct, or if you do not provide directions with respect to a proposal, in the manner recommended by the Board of Directors in this proxy statement. You may direct the proxy holders to vote for or against a proposal or to abstain from voting.

Q. Who is soliciting proxies on behalf of Southwall? Who pays the expenses of the proxy solicitation?

A. Our directors, officers and employees may solicit proxies in person or by mail, telephone, facsimile or electronic mail. We have also retained a proxy solicitor, The Altman Group, to assist in the solicitation of proxies for the annual meeting at an estimated cost to us of between \$10,000 and \$15,000, plus reimbursement of reasonable expenses. We will reimburse brokers and other nominee holders of shares for expenses they incur in forwarding proxy materials to beneficial owners of those shares.

Q. What proposals am I being asked to approve as a Southwall stockholder?

A. We are asking for you to approve the following proposals, each of which is more fully described in the proxy statement:

Proposal 1

Proposal 2

Proposal 3

the election of directors to serve for the ensuing year.

the amendment of our certificate of incorporation to increase the number of authorized shares of common stock from 20,000,000 to 50,000,000, and the total number of authorized shares of capital stock from 25,000,000 to 55,000,000.

the approval of an amendment of our 1997 Stock Incentive Plan to increase the number shares reserved for issuance thereunder from 2,150,000 to 6,150,000 and to make certain other changes to the plan, including to eliminate the evergreen

provision that automatically on the first day of each year has increased the number of shares available for issuance under the plan by 250,000.

Proposal 4 the approval of our 1998 Stock Plan for Employees and Consultants, as amended to increase the number of shares reserved for issuance thereunder from 1,150,000 to 2,400,000 and to make certain other changes to the plan, including to eliminate the evergreen provision that automatically on the first day of each year has increased the number of shares available for issuance under the plan by 150,000.

Q. Who may vote at the annual meeting?

A. Only holders of our common stock at the close of business on the record date, June 30, 2004, are entitled to receive notice of, and to vote their shares at, the annual meeting. As of the record date, there were issued and outstanding shares of common stock. At the annual meeting, you will be entitled to one vote for each share of common stock you held on the record date.

Q. How do I vote?

A. You may vote your shares at the annual meeting in person or by proxy:

- TO VOTE IN PERSON, you must attend the annual meeting, and then complete and submit the ballot provided at the annual meeting.
- TO VOTE BY PROXY, you must complete and return the enclosed proxy card. Your proxy card will be valid only if you sign, date and return it before the annual meeting. By completing and returning the proxy card, you will direct the designated persons to vote your shares at the annual meeting in the manner you specify in the proxy card. If you complete the proxy card with the exception of the voting instructions, then the designated persons will vote your shares in favor of the proposal described in this proxy statement. If any other business properly comes before the annual meeting, the designated persons will have the discretion to vote your shares as they deem appropriate.

Q. What if a broker holds my shares in street name ?

A. If your shares are held in street name by a broker or other nominee, your broker or other nominee will not be able to vote your shares prior to the annual meeting (whether in person or otherwise) unless you have given your broker or other nominee instructions to vote your shares on the proposals described in this proxy statement. You should instruct your broker or other nominee to vote your shares by following the procedure provided by your broker or other nominee. You may also attend the annual meeting and vote in person. If you elect to vote in person, however, you must bring to the annual meeting a legal proxy from the broker or other nominee authorizing you to vote the shares.

Q. What will happen if I do not give my broker or other nominee instructions on how to vote my shares?

A. If your shares are held in street name, your broker or other nominee will be prohibited under applicable regulations from using its discretion to vote your shares on the proposals to approve the amendment to our charter, to approve the amendments to the 1997 Plan and to approve the 1998 Plan. If your broker or other nominee instructs us that you have not provided instructions on how to vote on those proposals, your shares will be treated as broker non-votes with respect to those proposals. However, even if you do not give your broker or other nominee instructions as to how to vote on the other proposals described in this proxy statement, your broker or other nominee may be entitled to use its discretion in voting your shares in accordance with industry practice.

Q. May I revoke my proxy?

A. Yes. Even if you complete and return a proxy, you may revoke it at any time before it is exercised by taking one of the following actions:

- send written notice that you wish to revoke your proxy to Maury Austin, our corporate Secretary, at our address set forth in the Notice of Annual Meeting appearing before this proxy statement;
- send us another signed proxy with a later date; or
- attend the annual meeting, notify Mr. Austin that you are present, and then vote in person.

If, however, you elect to vote in person at the annual meeting and a broker or other nominee holds your shares, you must bring to the annual meeting a legal proxy from the broker or other nominee authorizing you to vote the shares.

Q. How many shares must be present in person or by proxy to transact business at the annual meeting?

A. Our by-laws require that shares representing a majority of the votes entitled to be cast by the holders of common stock outstanding on the record date be present in person or by proxy at the annual meeting to constitute a quorum to transact business with regard to each of the proposals. Shares as to which holders abstain from voting as to a particular matter and broker non-votes will be counted in determining whether there is a quorum of stockholders present at the annual meeting.

Q. How many votes are required to approve the approvals?

A. The votes necessary to approve each of the proposals is as follows:

- *Election of Directors.* The six nominees receiving the highest number of votes cast at the annual meeting will be elected, regardless of whether that number represents a majority of the votes cast.
- *Amendment of the charter.* The affirmative vote of a majority of the common stock outstanding on the record date is required to approve the amendment to our certificate of incorporation.
- *Amendments of our 1997 Stock Incentive Plan and our 1998 Stock Plan for Employees and Consultants.* The affirmative vote of a majority of the total number of votes cast at the meeting is needed to approve the amendment to our 1997 Plan and our 1998 Plan.

Abstentions and broker non-votes will not be counted as votes in favor of a proposal, and will also not be counted as votes cast or shares voting on such proposal. Accordingly, abstentions and broker non-votes will have no effect on the outcome of voting with respect to Proposals 1 (election of directors), 3 (amendment to 1997 Plan) and 4 (1998 Plan), because each of those proposals requires an affirmative vote of a majority of the shares of common stock present or represented by proxy. Abstentions and broker non-votes, however, will have the effect of negative votes with respect to Proposal 2 (the amendment of our charter), because that proposal requires the affirmative vote of the holders of a majority of all outstanding shares of common stock.

Q. What if additional proposals are presented at the annual meeting?

A. If other proposals are properly presented at the annual meeting for consideration, the persons named in the proxy card will have the discretion to vote on those proposals for you. As of the date of the mailing of this proxy statement, we do not know of any other proposals to be presented at the annual meeting.

Q. Whom can I contact for more information regarding the proxy materials or voting my shares?

A. If you have any additional questions about the proposals in this proxy statement, you should contact Maury Austin, our Chief Financial Officer, by telephone at (650) 962-9111 or by e-mail to maustin@southwall.com.

About the Proposals

Q. Why is Southwall proposing to amend its charter to increase the number of authorized shares?

A. Under Delaware corporate laws, we are required to obtain approval from our stockholders to amend our charter to increase the number of shares authorized for issuance. After taking into consideration our current outstanding equity obligations, together with our obligations under the investment agreement and related documents in connection with the financing described in this proxy statement, our Board of Directors has unanimously determined that it is necessary to increase the number of shares of common stock authorized for issuance by 30,000,000. Currently, we do not have authorized a sufficient number of shares of common stock to cover the maximum number of shares we would be required to issue if the holders of all of our outstanding convertible notes, warrants and options sought to convert and exercise, as applicable, those instruments into common stock. If our stockholders do not approve the charter amendment, the convertible notes will become due and payable and holders of our options, warrants and convertible notes may bring legal suits against us if they seek to exercise or convert, as applicable, such instruments and we do not have sufficient shares available. If such lawsuits were brought and were successful, there could be a material adverse effect on our financial position and results of operations, including the possibility that Southwall would need to file for bankruptcy. Furthermore, we have agreed, pursuant to the terms of the investment agreement to call a meeting of our stockholders to vote on the increase in our authorized capital stock

Q. How many shares of common stock will be available for issuance under the charter if the charter amendment is approved after giving effect to shares outstanding and shares reserved for issuance pursuant to outstanding options, warrants, convertible notes and stock plans.

A. If our stockholders approve the charter amendment, we expect to have approximately 10,400,000 shares of common stock that are not outstanding or reserved for issuance pursuant to outstanding options, warrants and convertible notes. The additional authorized shares would be available for issuance from time to time in the discretion of the Board, without further stockholder action except as may be required for a particular transaction by applicable law or other policies. Of those additional authorized shares, approximately 5,150,000 would be reserved for issuance to cover shares underlying options available but unissued under our option plans.

Q. What other alternatives did Southwall explore prior to entering into this financing?

A. During 2003, we experienced a significant deterioration in our working capital position, which has raised concerns about our ability to fund our operations and continue as a going concern in the short term and our ability to meet obligations coming due over the next few years.

On October 8, 2003, our management reviewed the revenue forecast for the fourth quarter of 2003 and determined the anticipated sales for the quarter would not generate enough cash flow to continue operations through the end of the quarter. Management presented its findings to our Board of Directors on October 10, 2003, and the directors instructed our management team to develop an emergency restructuring plan to improve our cash flow and to obtain new financing.

The primary elements of management's restructuring plan included:

- Shutting down a majority of our domestic manufacturing and transferring that production to our Dresden, Germany facility;
- Undertaking a series of staggered layoffs;
- Arranging new payment terms with major creditors and vendors to extend or reduce our payment obligations;

- Accelerating our cash collections;
- Reducing our operating expenses and inventory levels;

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- Minimizing our capital expenditures; and
- Seeking new sources of funding.

We also began to solicit and receive proposals from potential investors and lenders. We evaluated a variety of public and private market alternatives to raise additional capital, as well as alternatives to restructure our upcoming payment obligations without raising additional capital. Our access to the traditional capital markets was, and continues to be, constrained, however, by a number of factors, including our financial position and results of operations, as well as the risks described in our filings with the SEC. As a result, we concluded that a private equity investment was the most attractive alternative to continue as a going concern.

We received and evaluated three financing proposals, including the Needham proposal, which is described in further detail below. One proposal consisted of an initial offer to purchase up to \$3.0 million of our common stock, in two tranches, at a price equal to 70% of the average closing price of our common stock on the Nasdaq National Market during the 10 days preceding the closing dates. The initial tranches would have consisted of \$2.0 million of our common stock, with the additional \$1.0 million of common stock to have been purchased at the option of the investor within 18 months of the closing of the initial tranche. In addition, the investor would have received warrants for approximately 6,000,000 shares of our common stock, exercisable for five years at a per share exercise price equal to 110% of the closing price of our common stock on the Nasdaq National Market as of the business day prior the closing of the initial equity tranche. Another proposal contemplated the issuance of a \$2.0 million letter of credit to PBF, against which we would have been able to borrow under our existing domestic factoring agreement with PBF. After reviewing and seeking to negotiate revisions to all of the proposals submitted, the Board unanimously determined to proceed with the Needham offer, primarily because the Board believe that the amount of cash that we would have received under each of the two other proposals would have been insufficient to meet our short-term operational cash flow requirements.

Q. What percentages of Southwall do Needham and its affiliates and Dolphin own as a result of the financing?

A. As a result of the consummation of the transactions contemplated by the investment agreement, based on securities outstanding as of March 28, 2004, the following convertible securities and warrants are held by the Investors:

- if Needham and its affiliated entities were to exercise all of their warrants and convert all of their Series A shares (issuable upon conversion of their convertible notes), while maintaining their current ownership of approximately 2,200,067 shares of common stock, then Needham and its affiliated entities would own approximately 15,081,834 shares of our common stock, or about 59.3% of the total shares outstanding, including such issuances to Needham and its affiliates but excluding outstanding warrants and Series A shares held by other Investors.
- if Dolphin Direct Equity Partners, LP were to exercise all warrants and convert all of its Series A shares (issuable upon conversion of its convertible notes), then Dolphin would own approximately 5,499,769 shares of our common stock, or about 30.5% of the total shares outstanding, including such issuances to Dolphin but excluding outstanding warrants and Series A shares held by other Investors.

In addition, the convertible notes held by the Investors accrue interest 10% per year, compounded daily, payable each December 31st, which interest is also convertible into Series A shares, and the Series A shares are entitled to a cumulative dividend of 10% per year, accruing daily, payable at the discretion of the Board, which dividends are convertible into common stock.

Q. Will the transactions contemplated pursuant to the investment agreement affect Southwall's reported earnings per share?

A. Yes. The increase in the number of shares outstanding will result in lower earnings per share. Although we expect to incur a loss each quarter through at least the third quarter of 2004, if we have a profitable quarter, we expect that, based on securities outstanding as of March 28, 2004, earnings per share on a fully-diluted basis will be diluted by approximately 60% to 65%, compared to earnings per share on a fully-diluted basis had the financing and related transactions not been consummated.

Q. How will we spend the \$4,500,000 raised from the sale of the convertible notes?

A. After deducting approximately \$500,000 in professional fees related to the financing and restructuring, the net proceeds of the financing were approximately \$4,000,000. We applied the net proceeds as follows:

- approximately \$2,200,000 was spent during February and March of 2004, in the normal course of our business for general corporate purposes, including purchases of raw materials, payments to subcontractors and suppliers of approximately \$1,000,000, payroll costs of approximately \$800,000, and rent and lease payments;
- approximately \$800,000 was paid between February 24, 2004 and March 30, 2004, to Judd Properties, LLC, the landlord of our Palo Alto executive offices and manufacturing facilities, in connection with the settlement and restructuring of our lease obligations to Judd Properties, LLC; and
- approximately \$1,000,000 has been put up to support a letter of credit in favor of Judd Properties as security for our obligations to depart from and properly restore the property pursuant to our settlement and restructuring with Judd. We have agreed with Judd that, following stockholder approval of the amendment to our charter (Proposal 2), we may substitute a warrant exercisable for 1,437,396 shares of our common stock for the letter of credit as security for our obligations, in which event we will have access to the \$1,000,000 that currently supports the letter of credit. We expect that that \$1,000,000, if we were to substitute the warrant as security for our obligations to Judd, would be used for working capital and general corporate purposes.

Q. Will there be any adverse consequences to Southwall if the stockholders do not approve Proposal 2?

A. If we do not obtain stockholder approval of Proposal 2, we will be unable to meet our obligations to issue shares of capital stock under the investment agreement, and we will be required to repay the aggregate principal amount of \$4,500,000 under the convertible notes plus interest to the holders of the convertible notes 45 days following the annual meeting. If the holders of the convertible notes were to demand payment following a failure to approve the charter amendment, there would be an event of default under our senior loan agreements, and it is highly unlikely that we would be able to repay or refinance the amounts then due under the convertible notes and our senior loan obligations. In such an event, Southwall might be required to file for bankruptcy. In addition, without the proceeds from the convertible notes, the amount of capital available to us for general working purposes will be severely limited and we will not be able to fund our operations, service our existing debt obligations or continue as a going concern. In the likely event we are unable to secure an alternative financing plan, we will become insolvent and be required to file for bankruptcy protection. Furthermore, there can be no assurances that we will not be sued by the holders of our options, warrants or convertible notes if we do not have enough authorized shares of common stock to make the required issuances if they seek to exercise or convert those securities, as applicable.

PROPOSAL 1

ELECTION OF DIRECTORS

There are currently eight members of our Board of Directors. The Board has fixed the number of directors for the ensuing year at six and has nominated for such positions the six people listed below, other than Bruce M. Jaffe and Robert C. Stempel, who have decided not to stand for reelection to the Board. As a condition to the Investors investments under the investment agreement, we placed George Boyadjieff on our Board of Directors as Chairman. Noriyuki Nakamura resigned as a director in February 2004. The persons named in the enclosed proxy card as proxies will vote to elect each of the nominees unless you withhold authority to vote for the election of one or more nominees by marking the proxy card to that effect. Each of the six nominees has agreed to serve, but if any of them shall become unable or unwilling to serve, the proxies, unless authority has been withheld as to such nominee, may be voted for election of a substitute nominee designated by our Board of Directors or the Board may reduce the number of directors. Proxies may not be voted for more than six persons.

There are no family relationships among any of our executive officers or directors.

The following information as of the date of this proxy statement is furnished with respect to each director and nominee for election as a director. The information presented includes information each director and nominee has given us about his age, all positions he holds with us, his principal occupation and business experience during the past five years, and the names of other publicly-held companies of which he serves as a director. Information about the number of shares of common stock beneficially owned by each director or nominee, directly and indirectly, as of March 28, 2004, appears above under the heading Security Ownership of Certain Beneficial Owners and Management.

Name	Age
William A. Berry(2)	65
George Boyadjieff, Chairman(3)	65
Thomas G. Hood	48
Bruce M. Jaffe(1)(2)	60
Jami K. Nachtsheim(1)(3)	45
Joseph B. Reagan(1)(2)	69
Walter C. Sedgwick(1)(3)	57
Robert C. Stempel(2)	70

- (1) Member of the Compensation Committee.
- (2) Member of the Audit Committee.
- (3) Member of the Nominating and Corporate Governance Committee.

Mr. Berry has served on our Board of Directors since May 2003. Since July 2003, Mr. Berry has served as a Special Projects Manager of EPRI, the Electric Power Research Institute, a non-profit energy research organization providing science and technology-based solutions to global energy companies. From April 1997 to July 2003, Mr. Berry served as the Chief Financial Officer of EPRI. From 1992 to March 1996, Mr. Berry was the Senior Vice President and Chief Financial Officer of Compression Labs, Inc., a manufacturer of visual communications systems based on digital technology, and from 1989 to 1992 was the President of Optical Shields, Inc. Mr. Berry worked at Raychem Corporation from 1967 until 1988, where he was a Corporate Vice President and Chief Administrative Officer from 1985 to 1988. He is a director of FAFCO, Inc., a manufacturer of solar pool heating systems. Mr. Berry holds a BS in industrial engineering and an MBA from Stanford University.

Mr. Boyadjieff joined our Board of Directors as Chairman on December 19, 2003. Mr. Boyadjieff was the Chief Executive Officer of Varco International, Inc., a diversified oil service company, from 1991 through 2002, and the chairman of Board of Directors of Varco from 1998 through 2003. Mr. Boyadjieff

retired from active leadership of Varco in 2003. Mr. Boyadjieff holds a BS and an MS in mechanical engineering from the University of California at Berkeley.

Mr. Hood has served as our President and Chief Executive Officer since July 1998 and as a member of our Board of Directors since March 1998. From March 1998 until July 1998, he served as Interim President and Chief Executive Officer. From July 1996 to March 1998, he served as Senior Vice President, General Manager, Energy Products Division. From January 1995 to July 1996, he was Vice President, General Manager, International Operations, and from October 1991 to January 1995, he was Vice President, Marketing and Sales. He is the inventor of record on ten of our patents. Mr. Hood has an MS degree in Mechanical Engineering from New Mexico State University and a BS in mechanical engineering from Union College.

Mr. Jaffe has served as a member of our Board of Directors since April 2003. Since November 2000, Mr. Jaffe has served on the Audit Committee and Board of Directors of Metron Technology, a leading global provider of marketing, sales, service and support solutions to semiconductor materials and equipment suppliers and semiconductor manufacturers. Since August 2000, Mr. Jaffe has served on the Audit Committee and Board of Directors of Pemstar, Inc., a provider of engineering, manufacturing and fulfillment services. Since April 2003, Mr. Jaffe has served as Vice President and Chief Financial Officer of LogicVision, Inc., a software developer for embedded test technology for semiconductors. From July 1997 to July 1999, Mr. Jaffe served as the Chief Financial Officer of Bell Microproducts, an international, value-added provider of high-technology products, solutions, and services to the industrial and commercial markets. From October 1967 to November 1996, Mr. Jaffe served in a variety of management positions with Bell Industries including, President, Chief Operating Officer and Chief Financial Officer. He was also a director of Bell Industries from 1981 to 1996. Mr. Jaffe holds a BS in Business Accounting from the University of Southern California.

Ms. Nachtsheim has been a member of our Board of Directors since April 2003. Ms. Nachtsheim retired in June 2000 after 20 years with Intel Corporation, a semiconductor chipmaker. Ms. Nachtsheim served in a variety of positions at Intel, most recently as Corporate Vice President of the Sales and Marketing Group and Director of Worldwide Marketing, from 1998 until her retirement. From January 2003 to December 2003, Ms. Nachtsheim served on the Board of Directors of Vixel Corporation, a creator of disruptive storage networking technologies. Ms. Nachtsheim is a graduate of Arizona State University with a bachelor degree in Business Management.

Dr. Reagan has served as a member of our Board of Directors since June 1993 and was Chairman of the Board of Directors from May 2000 until December 2003. He previously served as a director from October 1987 through May 1992. Dr. Reagan is a technology and senior management consultant to industry and to the United States Government. He retired in 1996 after 37 years with the Lockheed Martin Corporation where he was a Corporate Vice President and General Manager of the Research and Development Division of the Missiles and Space Company. Dr. Reagan holds BS and MS degrees in Physics from Boston College and a PhD in Space Science from Stanford University.

Mr. Sedgwick has served as a member of our Board of Directors since January 1979. Mr. Sedgwick has been a private investor since 1994.

Mr. Stempel has served as a member of the Company's Board of Directors since May 2000. He is Chairman of Energy Conversion Devices, Inc. (ECD), an energy and information company headquartered in Troy, Michigan. In February 2004, Mr. Stempel was appointed Chief Executive Officer of ECD. Mr. Stempel retired as Chairman and Chief Executive Officer of General Motors Corporation in November 1992. He was named Chairman and Chief Executive Officer in August 1990. Prior to serving as Chairman, he had been President and Chief Operating Officer of General Motors since September 1987.

The Board of Directors recommends a vote **FOR** the election of all of the above nominees that are nominated for election as directors.

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PROPOSAL 2
CHARTER AMENDMENT TO INCREASE
THE NUMBER OF AUTHORIZED SHARES

Overview

At the annual meeting, we will ask our stockholders to approve an amendment to our certificate of incorporation to increase the number of authorized shares of common stock from 20,000,000 to 50,000,000. In addition, to effect this change, the total number of shares of capital stock authorized in our charter would be increased from 25,000,000 to 55,000,000.

Under Delaware corporate law, we are required to obtain approval from our stockholders to amend our charter to increase the number of shares authorized for issuance. After taking into consideration our current outstanding equity obligations, together with our obligations under the investment agreement and related documents in connection with the financing described in this proxy statement, our Board of Directors has unanimously determined that it is necessary to increase the number of shares of common stock authorized for issuance by 30,000,000. Currently, we do not have authorized a sufficient number of shares of common stock to cover the maximum number of shares we would be required to issue if the holders of all of our outstanding convertible notes, warrants and options sought to convert and exercise, as applicable, those instruments into common stock. If our stockholders do not approve the charter amendment, holders of our options, warrants and convertible notes may bring legal suits against us if they seek to exercise or convert, as applicable, such instruments and we do not have sufficient shares available. If such lawsuits were brought and were successful, there could be a material adverse effect on our financial position and results of operations, including the possibility that Southwall would need to file for bankruptcy.

In addition, if the charter amendment is not approved at the annual meeting, the convertible notes that we issued to Needham and its affiliates and Dolphin in the aggregate principal amount of \$4,500,000 shall become due and payable 45 days following the date of the annual meeting. If the holders of the convertible notes were to demand payment following a failure to approve the charter amendment, there would be an event of default under our senior loan agreements, and it is highly unlikely that we would be able to repay the amounts then due under the convertible notes and our senior loan agreements. Without the proceeds from the convertible notes, the amount of capital available to us for general working purposes will be severely limited and we will not be able to fund our operations, service our existing debt obligations or continue as a going concern. In the likely event we are unable to secure an alternative financing plan, we will become insolvent and be required to file for bankruptcy.

If approved by our stockholders, the increase in authorized shares would become effective as soon as upon our filing of a certificate of amendment to our charter with the Delaware Secretary of State, which we intend to do promptly after approval of the annual meeting.

Reasons for Proposal

Our charter currently authorized us to issue up to 25,000,000 shares of capital stock, consisting of 20,000,000 shares of our common stock and 5,000,000 shares of preferred stock. Our authorized preferred stock has all been designated as Series A 10% Cumulative Convertible Preferred Stock, or Series A shares. The Series A shares, which are reserved for issuance upon conversion of our convertible notes, are described below. The table below depicts our outstanding common stock and common stock equivalents as of March 28, 2004. The percentages below are based on the actual number of shares of common stock outstanding on March 23, 2004, plus the maximum number of shares of common stock issuable upon conversion of the convertible notes and exercise of all outstanding warrants and options and shares reserved for issuance under our stock plans (as amended) (that is, 39,560,768 shares).

	Shares	Percent of Fully-Diluted Shares
Common Stock issued and outstanding(1)	12,631,072	32 %
Common Stock issuable upon conversion of convertible notes(2)	4,500,000	11 %
Common Stock issuable upon exercise of warrants	14,241,536	36 %
Common Stock issuable upon exercise of outstanding options(3)	3,041,548	8 %
Common stock available for issuance under existing stock option and stock purchase plans(4)	5,146,612	13 %

(1) Includes 82,880 shares of common stock, we have committed to issue, following the approval of our stockholders of the charter amendment, to members of our Board of Directors in lieu of cash fees to which they are otherwise entitled.

(2) As discussed below, the convertible notes are convertible, at each holder's option, into Series A shares, which are convertible, at each holder's option, into shares of common stock. The number of shares in the table above assumes the conversion of the aggregate principal amount of \$4,500,000 of the convertible notes but not any accrued but unpaid interest. Interest, which accrues on the convertible notes at the rate of 10% per annum, compounded daily, is payable each December 31st and is also convertible into Series A shares.

(3) Includes options to purchase 390,000 shares we have committed to issue to George Boyadjieff, the chairman of our Board of Directors, upon the approval by our stockholders of the charter amendment.

(4) Including the additional shares of common stock proposed to be added to our 1997 Stock Incentive Plan and 1998 Stock Plan for Employees and Consultants by Proposals 3 and 4 below.

As of March 28, 2004, the total number of our outstanding shares of common stock together with our future obligations to issue common stock (not including shares of common stock that we have reserved under our existing stock plans but do not underlie outstanding options) exceeds the number of shares we have authorized under our charter by approximately 14,500,000. Therefore, if the holders of all of our outstanding convertible notes, warrants and options seek to convert or exercise, as applicable, those instruments into shares of common stock, we will not have a sufficient number of shares of common stock available, unless we have amended our charter. If our stockholders approve the amendment to our charter, we will have approximately 10,400,000 shares of common stock available for future issuances in excess of our outstanding common stock, our future obligations to issue common stock, and other shares we have reserved for issuance under our stock plans.

The Board of Directors believes that it is very important to have available for issuance a number of authorized shares of common stock that will be available for our future corporate needs, above the number of shares required to meet our obligations described above. The additional authorized shares would be

available for issuance from time to time in the discretion of the Board, without further stockholder action except as may be required for a particular transaction by applicable law or other policies. The shares would be issuable for any proper corporate purpose, including future acquisitions, capital raising transactions consisting of either equity or convertible debt, stock splits or issuances under current and future stock plans. The Board believes that these additional shares will provide us with needed flexibility to issue shares in the future without potential expenses and delays incident to obtaining stockholder approval for a particular issuance. Except to the extent of our existing obligations on the date of the mailing of this proxy statement and the matters described herein, we do not currently have any plans, understandings or agreements for the issuance or use of the additional shares of common stock to be approved under this proposal.

Financing and Related Transactions

Overview

On December 18, 2003, to raise cash to fund our operations and continue as a going concern, we entered into an investment agreement with Needham & Company, Inc., Needham Capital Partners II, L.P., Needham Capital Partners II (Bermuda), L.P., Needham Capital Partners III, L.P., Needham Capital Partners IIIA, L.P., Needham Capital Partners III (Bermuda), L.P., and Dolphin Direct Equity Partners, LP, collectively, the Investors. On February 20, 2004, we amended and restated that agreement. Under the terms of that agreement, we agreed to issue and sell \$4.5 million of Secured Convertible Promissory Notes that are convertible into our Series A 10% Cumulative Convertible Preferred Stock, par value \$.001 per share, or the Series A shares, at a conversion price of \$1.00 per share, together with warrants initially exercisable for 13,881,536 shares of our common stock. If the Investors were to exercise all warrants and convert all Series A shares issuable to them pursuant to the terms of the investment agreement, our senior lender, Pacific Business Funding, or PBF, were to exercise all warrants currently issued to it, and our option holders were to exercise all options currently outstanding, we would have 34,414,156 shares of common stock outstanding. We currently have 20,000,000 shares of common stock authorized under our certificate of incorporation. At the annual meeting, we will seek approval of an amendment to our certificate of incorporation increasing the number of authorized shares available for issuance to a number that would allow us to meet fully our obligations to issue shares of capital stock under the investment agreement. If this Proposal 2 is not approved, the amounts due under the convertible notes will accelerate and we will not be able to meet our obligations under the investment agreement. The resulting lack of capital will prevent us from funding our operations and continuing as a going concern.

This proxy statement summarizes the material terms of the convertible notes, the certificate of designation for the Series A shares and the definitive agreements relating to the financing, including the investment agreement. The form of the Amended and Restated Certificate of Designation, Preferences and Rights of Series A 10% Cumulative Preferred Stock and the Amended and Restated Investment Agreement are included as exhibits to our Current Report on Form 8-K/A, dated and filed with the SEC on March 3, 2004. You are encouraged to read all of these materials carefully. The summaries of these materials in this proxy statement are qualified in their entirety by reference to these materials.

Background

During 2003, we experienced a significant decline in sales, which led to a significant deterioration in our working capital position, which raised concerns about our ability to fund our operations, continue as a going concern and meet our obligations.

In addition, in the third quarter of 2003, we determined that due to reduced demand for our products, anticipated revenues through the remainder of 2003 and 2004 would be substantially below historical levels. As our U.S. operations have a higher operating cash break-even point compared to our Dresden

operations, we believed that the lower than anticipated revenues indicated that an impairment analysis of the long-lived assets of our U.S. operations was necessary at September 28, 2003. Subsequently, in the fourth quarter of 2003, as a result of our decision to close the Tempe operation, we concluded that a further impairment analysis of the long-lived assets of the U.S. operation was necessary at December 31, 2003. Our evaluation concluded that an impairment charge was required to write down the carrying amount of our long-lived assets to their fair market values, of \$19.4 million and \$8.6 million for the periods ended September 28, 2003 and December 31, 2003, respectively.

On October 8, 2003, our management reviewed the revenue forecast for the fourth quarter of 2003 and determined the anticipated sales for the quarter would not generate enough cash flow to continue operations through the end of the quarter. Management presented its findings to our Board of Directors on October 10, 2003 and the directors instructed our management team to develop an emergency restructuring plan to improve our cash flow and to obtain new financing.

The primary elements of management's restructuring plan included:

- Shutting down a majority of our domestic manufacturing and transferring that production to our Dresden, Germany facility;
- Undertaking a series of staggered layoffs;
- Arranging new payment terms with major creditors and vendors to extend or reduce our payment obligations;
- Accelerating our cash collections;
- Reducing our operating expenses and inventory levels;
- Minimizing our capital expenditures; and
- Seeking additional funding sources.

We also began to solicit and receive proposals from potential investors and lenders. We evaluated a variety of public and private market alternatives to raise additional capital, as well as alternatives to restructure our upcoming payment obligations without raising additional capital. Our access to the traditional capital markets was, and continues to be, constrained, however, by a number of factors, including the risks described in our filings with the SEC. As a result, we concluded that a private equity investment was the most attractive alternative to continue as a going concern.

We received and evaluated three financing proposals, including the Needham proposal, which is described in further detail below. One proposal consisted of an initial offer to purchase up to \$3.0 million of our common stock, in two tranches, at a price equal to 70% of the average closing price of our common stock on the Nasdaq National Market during the 10 days preceding the closing dates. The initial tranches would have consisted of \$2.0 million of our common stock, with the additional \$1.0 million of common stock to have been purchased at the option of the investor within 18 months of the closing of the initial tranche. In addition, the investor would have received warrants for approximately 6,000,000 shares of our common stock, exercisable for five years at a per share exercise price equal to 110% of the closing price of our common stock on the Nasdaq National Market as of the business day prior the closing of the initial equity tranche. Another proposal contemplated the issuance of a \$2.0 million letter of credit to PBF, against which we would have been able to borrow under our existing domestic factoring agreement with PBF.

All three proposals, including the Needham proposal, were presented to our Board of Directors. After reviewing and seeking to negotiate revisions to all of the proposals submitted, the Board unanimously determined on November 10, 2003 to proceed with the Needham & Company, Inc. offer, primarily because the Board believed that the amount of cash that we would have received under each of the two other proposals would have been insufficient to meet our short-term operational cash flow requirements. We

entered into a non-binding letter of intent with Needham on November 11, 2003 to sell \$3.0 million of Series A shares at a price of \$1.00 per share. Needham also agreed to guarantee up to \$2.0 million of additional borrowing under our existing Domestic Factoring Agreement with our senior lender, PBF. In connection with the guarantee and the sale of the Series A shares, we agreed to issue warrants to Needham exercisable for a number of shares of our common stock equal to 10% of the total shares outstanding, at a nominal exercise price, which warrants terminated by their terms upon the execution of the investment agreement described below. During the negotiations of the investment agreement, the parties agreed to increase the aggregate number of Series A shares to be sold to 4.5 million. The parties also increased the guarantee to \$3.0 million and determined that it would apply to a new line of credit facility with PBF.

On December 18, 2003, we entered into the investment agreement with the Investors. Under the terms of the investment agreement, Needham agreed to issue the guarantees of our new line of credit facility in two separate tranches of \$2.25 million and \$750,000, respectively, and the Investors agreed to purchase the Series A shares in two separate tranches of \$1.5 million and \$3.0 million, respectively. The new borrowings and the purchase of each equity tranche were subject to certain conditions, including, among other things, the receipt of concessions by us from creditors and landlords, the completion by us of certain restructuring actions and the achievement of cash flow break-even at quarterly revenue levels below those of the third quarter 2003. Needham executed a guarantee of up to \$2.25 million under the new line of credit facility on December 18, 2003, and received a warrant to purchase 941,115 shares of our common stock, approximately 7.5% of our total shares currently outstanding at an exercise price of \$0.01 per share. On January 15, 2004, Needham executed a guarantee with respect to an additional \$750,000 under the new line of credit and received an additional warrant to purchase 941,115 shares of common stock at an exercise price of \$0.01 per share. A further description of the terms of all warrants is set forth below.

On February 20, 2004, the parties amended and restated the investment agreement to provide that we would issue and sell to the Investors an aggregate of \$4.5 million of our convertible notes in one tranche instead of Series A shares in two separate tranches. A further description of the convertible notes is set forth below. Under the investment agreement, and as further described in the Anti-Dilution Protection section below, we were also required to issue additional common stock warrants to the Investors as anti-dilution protection for the issuance of debt and equity by us as part of the restructuring of our obligations to creditors. In connection with the sale of the convertible notes and honoring the Investors anti-dilution protection, on February 20, 2004 we issued warrants to the Investors to purchase a total of 10,305,299 shares of our common stock, at an exercise price of \$0.01 per share, approximately 82.1% of our total shares currently outstanding.

Summary of Current Ownership by Investors

Following completion of the financing, based on securities outstanding as of March 28, 2004, the following convertible securities and warrants are held by the Investors:

- if Needham and its affiliated entities were to exercise all of their warrants and convert all of their Series A shares (issuable upon conversion of its convertible notes), while maintaining their current ownership of approximately 2,200,067 shares of common stock, then Needham and its affiliated entities would own approximately 15,081,834 shares of our common stock, or about 59.3% of the total shares outstanding, including such issuances to Needham and its affiliates but excluding outstanding warrants and Series A shares held by other Investors.
- if Dolphin Direct Equity Partners, LP were to exercise all warrants and convert all of its Series A shares (issuable upon conversion of its convertible notes), then Dolphin would own approximately 5,499,769 shares of our common stock, or about 30.5% of the total shares outstanding, including such issuances to Dolphin but excluding outstanding warrants and Series A shares held by other Investors.

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In addition, the convertible notes held by the Investors accrue interest 10% per year, compounded daily, payable each December 31st, which interest is also convertible into Series A shares, and the Series A shares are entitled to a cumulative dividend of 10% per year, accruing daily, payable at the discretion of the Board, which dividends are convertible into common stock.

Reasons for the Financing

In the short-term, the financing will enable us to fund our operations, continue as a going concern and meet our obligations, as they become due.

After deducting approximately \$500,000 in professional fees related to the financing and restructuring, the net proceeds of the financing were approximately \$4,000,000. We applied the net proceeds as follows:

- approximately \$2,200,000 was spent during February and March of 2004, in the normal course of our business for general corporate purposes, including purchases of raw materials, payments to subcontractors and suppliers of approximately \$1,000,000, payroll costs of approximately \$800,000, and rent and lease payments;
- approximately \$800,000 was paid between February 24, 2004 and March 30, 2004, to Judd Properties, LLC, the landlord of our Palo Alto executive offices and manufacturing facilities, in connection with the settlement and restructuring of our lease obligations to Judd Properties, LLC; and
- approximately \$1,000,000 has been put up to support a letter of credit in favor of Judd Properties as security for our obligations to depart from and properly restore the property pursuant to our settlement and restructuring with Judd. We have agreed with Judd that, following stockholder approval of the amendment to our charter (Proposal 2), we may substitute a warrant exercisable for 1,437,396 shares of our common stock for the letter of credit as security for our obligations, in which event we will have access to the \$1,000,000 that currently supports the letter of credit. We expect that that \$1,000,000, if we were to substitute the warrant as security for our obligations to Judd, would be used for working capital and general corporate purposes.

We believe the financing, along with our current restructuring of debt and operations and recent improvements in financial performance, will provide greater stability and position us for long-term growth.

Consequences if Stockholder Approval is Not Obtained

If we do not obtain stockholder approval of this Proposal 2, we will be unable to meet our obligations to issue shares of capital stock under the investment agreement, and we will be required to pay the aggregate principal amount of \$4,500,000 under the convertible notes plus interest to the holders of the convertible notes 45 days following the annual meeting. If the holders of the convertible notes were to demand payment following a failure to approve the charter amendment, there would be an event of default under our senior loan agreements, and it is highly unlikely that we would be able to repay or refinance the amounts then due under the convertible notes and our senior loan obligations. In such an event, Southwall might be required to file for bankruptcy. In addition, without the proceeds from the convertible notes, the amount of capital available to us for general working purposes will be severely limited and we will not be able to fund our operations, service our existing debt obligations or continue as a going concern. In the likely event we are unable to secure an alternate financing plan, we will become insolvent and be required to file for bankruptcy protection.

Furthermore, there can be no assurances that we will not be sued by the holders of our options, warrants or convertible notes if we do not have enough authorized shares of common stock to make the

required issuances if they seek to exercise or convert those securities, as applicable, or that those holders will not otherwise seek repayment of some or all of the amounts paid to us by them.

Principal Effects on Outstanding Common Stock

The financing will result in substantial dilution to our common stockholders. Based on securities outstanding as of March 28, 2004, our common stockholders would experience dilution of 147% if all convertible notes were converted into Series A shares and then into common stock and all warrants issued as part of the financing were exercised. Further dilution will occur if, as part of our restructuring efforts, we issue any equity or instruments exercisable or convertible into equity to any creditor, landlord, employee, director, agent or consultant. In such a situation we are required to issue additional warrants to each of the Investors in such amounts as would allow the Investors to maintain their aggregate ownership percentage (on a fully-diluted basis) as if such issuance had not occurred. Other than the dilutive effect on a stockholder's voting power, the nature and terms of such issuances could render more difficult or discourage an attempt to obtain a controlling interest in Southwall or the removal of the incumbent Board of Directors and may discourage unsolicited takeover attempts which might be desirable to stockholders.

The issuance of additional shares of common stock will also have a dilutive effect on our earnings per share and the trading price of our outstanding common stock may be reduced as a result of such issuances. Holders of common stock do not have any preemptive rights to subscribe for the purchase of any shares of common stock, which means that current holders of common stock do not have a prior right to purchase any new issue of common stock in order to maintain their proportionate ownership.

Holdings of common stock are entitled to one vote per share on all matters submitted to a vote of our stockholders and to receive ratably dividends, if any, as may be declared from time to time by the Board of Directors from funds legally available therefore, subject to the payment of any outstanding preferential dividends declared with respect to any preferred stock that may from time to time be outstanding. Upon our liquidation, winding up or dissolution, holders of common stock are entitled to share ratably in any assets available for distribution to stockholders after payment of all of our obligations, subject to the rights to receive preferential distributions of the holders of any preferred stock then outstanding.

Material Terms of the Secured Convertible Promissory Notes

In connection with the investment agreement, we issued convertible notes in an aggregate principal amount of \$4.5 million to the Investors. The convertible notes:

- are convertible, at each holder's option, into our Series A shares at a conversion price of \$1.00 per share;
- accrue interest at an annual rate of 10%, compounded daily, payable each December 31, which interest if accrued but unpaid is also convertible into Series A shares;
- are secured by a pledge of a portion of the stock of our subsidiary, Southwall Europe GmbH; and
- are due and payable on February 20, 2009 or earlier under certain circumstances. For instance, the failure of our stockholders to approve Proposal 2 (the amendment of our charter) will result in the acceleration of the convertible notes.

In addition, so long as any of the convertible notes are outstanding, the approval of the holders of a majority of the convertible notes will be required to effect the corporate actions set forth below under "Material Terms of the Series A Shares' General Voting Rights" of the Series A shares. The convertible notes are subordinate to the credit facilities with our senior lender, PBF.

Material Terms of the Series A Shares

Dividends on Series A Shares

Each of the Series A shares will have a stated value of \$1.00 and will be entitled to a cumulative dividend of 10% per year, payable at the discretion of the Board of Directors. Dividends on the Series A shares shall accrue daily commencing on the date of issuance and shall be deemed to accrue whether or not earned or declared and whether or not there are profits, surplus or other funds legally available for the payment of dividends. Accumulated dividends, when and if declared by the Board, will be paid in cash.

Restrictions

So long as any Series A shares are outstanding, unless all accrued dividends on all Series A shares have been paid, we are prohibited from:

- redeeming or purchasing any shares of our common stock (or any other capital stock ranking junior to the Series A shares in respect of dividends or liquidation preference), except the repurchase of shares of common stock held by officers, directors or employees, upon death, disability, or termination of employment;
- paying or declaring any cash dividend or making any cash distribution upon any shares of our common stock (or any other capital stock ranking junior to the Series A shares in respect of dividends or liquidation preference); and
- setting aside any monies for the purchase or redemption of any shares of our common stock (or any other capital stock ranking junior to the Series A shares in respect of dividends or liquidation preference), except as described above.

General Voting Rights

Except as described below or as otherwise provided by law, the holders of Series A shares have no voting rights. The approval of the holders of a majority of the Series A shares voting separately as a class will be required to effect certain corporate actions, including:

- the authorization or issuance of shares of any class or series of stock having any preference or priority as to dividends or redemption rights, liquidation preferences, conversion rights, or voting rights, superior to or on a parity with any rights of the Series A shares;
- the reclassification of any shares of capital stock into shares having any preference or priority as to dividends or redemption rights, liquidation preferences, conversion rights, or voting rights, superior to or on a parity with any rights of the Series A shares;
- the authorization or issuance of any debt or other obligations convertible into or exchangeable for any shares of stock having any preference or priority as to dividends or redemption rights, liquidation preferences, conversion rights, or voting rights, superior to or on a parity with any rights of the Series A shares;
- declaring or paying dividends on or making any distributions with respect to our common stock;
- increasing or decreasing the authorized number of Series A shares;
- amending or repealing any provision of, or adding any provision to, our certificate of incorporation or bylaws if such action would alter or change the preferences, rights, privileges or powers of, or the restrictions provided for the benefit of, any Series A shares;

- increasing the number of shares of common stock reserved for issuance under our stock option plans, other than the annual increase currently provided in such plans and other than a further increase of not more than 1,000,000 shares;
- engaging in any transaction or series of related transactions constituting a liquidation or dissolution of Southwall, the sale of all or substantially all of our assets, or the acquisition of Southwall by another entity; or
- making any material change to our line of business.

Liquidation Preference

Upon a liquidation or dissolution of Southwall, the holders of Series A shares are entitled to be paid a liquidation preference out of assets legally available for distribution to our stockholders before any payment may be made to the holders of common stock. The liquidation preference is equal to the stated value of the Series A shares, which is \$1.00 per share, plus any accumulated but unpaid dividends. Mergers, the sale of all or substantially all of our assets, or the acquisition of Southwall by another entity and certain other similar transactions may be deemed to be liquidation events for these purposes.

Conversion

Each of the Series A shares is convertible into common stock at any time at the option of the holder. Each of the Series A shares is convertible into a number of shares of common stock equal to the sum of its stated value plus any accumulated but unpaid dividends, divided by the conversion price of the Series A shares. The conversion price of the Series A shares is \$1.00 per share and is subject to adjustment in the event of any stock dividend, stock split, reverse stock split or combination affecting such shares. The Series A shares also have anti-dilution protection that adjusts the conversion price downwards using a weighted-average calculation in the event we issue certain additional securities at a price per share less than the closing price per share of our common stock on the Nasdaq National Market or any other stock exchange on which our common stock is listed. The weighted-average formula factors in the effect on all outstanding stock of certain additional securities issued at the lower price and adjusts the conversion price downwards based upon such overall effect on our capitalization. Therefore, the more shares that are issued at the lower price, and the lower the price at which the shares are issued, the greater the downward adjustment to the conversion price. Each Series A share is initially convertible into one share of common stock. If the conversion price is adjusted downwards, each Series A share will be convertible into more than one share of our common stock and our common stockholders will experience further dilution. In the event the anti-dilution provision are triggered, the new conversion price will be determined by multiplying the Series A conversion price in effect immediately prior to such issuance by the following:

(A) the sum of (i) the number of shares of common stock outstanding immediately prior to such issue and (ii) the number of shares of common stock which the aggregate amount of cash received by us for the additional securities would purchase at the closing price per share of the common stock on the Nasdaq National Market or other stock exchange on which the common stock is listed

divided by,

(B) the total number of shares of common stock outstanding immediately after the issuance of the additional shares.

The following example demonstrates the application of the weighted-average formula and assumes the conversion price is \$1.00, 12,000,000 shares of common stock are outstanding prior to the issuance of the additional securities, the closing price of the common stock on the applicable exchange \$4.00 and we issue 1,000,000 shares of common stock at \$2.00 per share. Given these assumptions, by way of example only, the weighted-average formula would be as follows: \$1.00 multiplied by (12,000,000 plus (2,000,000

divided by \$4.00)) divided by 13,000,000, resulting in a new conversion price for the Series A shares of \$0.96, meaning that each Series A share would be convertible into approximately 1.04 shares of common stock.

No such adjustments of the conversion price will be made upon the issuance of shares or options pursuant to (i) our stock option plans, (ii) agreements with the holders of the Series A shares, (iii) the conversion of the Series A shares, or (iv) certain transactions for which certain stockholders will be entitled to receive common stock or securities convertible into common stock under the investment agreement.

If the closing price of our common stock on the Nasdaq National Market or any other stock exchange on which our common stock is listed is \$4.00 or more per share (subject to appropriate adjustment if a stock split, reverse split or similar transaction is effected) for 30 consecutive days, all outstanding Series A shares shall automatically be converted. The closing price of our common stock on the Over-the-Counter Bulletin Board on June 25, 2004, was \$0.46 per share.

Redemption

The Series A shares are not redeemable.

Material Terms of the Warrants

Investor Warrants

In connection with the investment agreement, we issued warrants to the Investors that may be exercised to acquire up to 13,881,536 shares of common stock (including warrants issued to the Investors as anti-dilution protection for the issuance of debt and equity by us as part of the restructuring of our obligations to creditors) at an initial exercise price of \$0.01 per share. The number of shares and the exercise price are both subject to appropriate adjustment in the event of stock splits, reverse stock splits and the granting of a stock dividend on our outstanding common stock. These warrants will be exercisable for cash or through a cashless exercise feature. The warrants are exercisable immediately and have a term of approximately five years.

Upon the reclassification of our common stock or a capital reorganization, each holder of these warrants has the right to receive the same amount and kind of securities, cash or property upon exercise as it would have been entitled to receive had it been the owner of the shares of common stock underlying the warrants at the time of such transaction. Upon a merger or consolidation, a transfer of all or substantially all of our voting securities, or the sale of all or substantially all of our assets, the warrants will terminate if they have not been previously exercised. The holders of the warrants have registration rights under the registration rights agreement described below.

On December 18, 2003, we issued warrants to the Investors exercisable for 941,115 shares of our common stock. The closing price of our common stock on the Nasdaq National Market on that date was \$0.88 per share. On January 15, 2004, we issued warrants to the Investors exercisable for another 941,115 shares of our common stock. The closing price of our common stock on that date was \$1.29 per share. On February 20, 2004, we issued a third tranche of warrants to the Investors exercisable for 11,999,306 shares of our common stock. The closing price of our common stock on that date was \$1.58 per share. In many cases the current price of a company's common stock is used as the basis of determining the fair value of issued warrants. We concluded, however, that it was inappropriate to use the quoted price of the common stock as a basis for valuing the warrants for accounting purposes because the stock was thinly traded and because of the extent of the dilution resulting from the transactions under the investment agreement. We retained independent appraisers, Standard & Poor's, to assist us in valuing the warrants for purposes of preparing our financial statements. After speaking with our management, reviewing our financial forecasts, analyzing our competitors and their financial positions completed an independent appraisal of our

enterprise value and apportioned that value among the various debt and equity securities, including the warrants issued by us. Standard & Poor's estimated the fair value of the warrants issued to the Investors to range between \$0.39 to \$0.44 per share of common stock depending on the specific dates of issuance.

PBF Warrants

In connection with the credit facilities with our senior lender, PBF, we issued warrants to PBF that may be exercised to acquire up to 360,000 shares of common stock at an initial exercise price of \$0.01 per share. All other terms of these warrants mirrored the terms of the warrants issued to the Investors.

Material Terms of Registration Rights Agreement

Under a registration rights agreement we entered into in connection with the issuance of securities and the warrants described above, we granted the Investors and PBF registration rights with respect to certain shares of common stock issuable upon conversion of such Series A shares and warrants. Pursuant to the registration rights agreement, after December 18, 2004, we are required to file up to three demand registration statements with the SEC upon the written request of holders of 50% or more of the securities that are subject to the registration rights agreement as long as they are requesting the registration of at least 40% or more of the securities that are subject to the registration rights agreement. After December 18, 2004, if we are eligible to use a simplified registration form, we are required to file demand registration statements with the SEC upon the written request of holders of 50% or more of the securities that are subject to the registration rights agreement as long as the securities that are requested to be registered are anticipated to have an aggregate price to the public of at least \$1,000,000. We are entitled to delay any demand for registration for up to 90 days if the registration would be seriously detrimental to Southwall. In addition, we have granted the Investors and PBF unlimited incidental, or piggyback, registration rights to have the securities listed above included in any registration statement, subject to certain restrictions, which we propose to file. We are required to use reasonable efforts to cause all registration statements to be declared effective for a period ending on the earlier of one year from the date a registration statement is declared effective or the date on which all shares of common stock registered pursuant to such registration statement are sold. The registration rights, with respect to each holder of the rights, will terminate on the date on which all shares of common stock of such holder subject to the registration rights agreement may be sold without registration pursuant to Rule 144 of the Securities Act of 1933, as amended, or the Securities Act. We will pay for the costs associated with each registration. In addition, one of our creditors, Judd Properties, LLC, is a party to the registration rights agreement. See Agreements with Major Creditors Judd Properties, LLC.

Observation Rights

Under the investment agreement, we agreed that for so long as Needham or any of its affiliates owns 5% or more of our common stock (on a fully-diluted basis) or any portion of Needham's guarantee of the PBF credit agreement remains in effect, we will permit one Needham designee to attend all of our Board meetings.

Relationships with Needham & Company, Inc.

Needham & Company, Inc. was the lead managing underwriter of our follow-on public offering that was completed in July 2002. In connection with that offering, Needham & Company, Inc. received approximately \$543,375 in the form of underwriting discounts. In addition, Bruce J. Alexander, a managing director of Needham & Company, Inc. was a member of our Board of Directors from May 1981 until May 2003.

Other Agreements with the Investors

Issuance of Equity

Other than certain issuances of equity in connection with our option plan and as part of the restructuring of our obligations to creditors, the investment agreement contains provisions that prohibit us from issuing any equity or warrants, options, rights or other instruments exercisable or convertible into equity of Southwall to any creditor, landlord, employee, director, agent or consultant until such time as we have received the approval of our stockholders to increase the number of authorized shares of our common stock issuable under our certificate of incorporation.

Anti-Dilution Protection

If, as part of our restructuring efforts, we issue any equity or warrants, options, rights or other instruments exercisable or convertible into equity, to any creditor, landlord, employee, director, agent or consultant, then we are required to issue additional warrants to each of the Investors in such amounts as would allow the investors to maintain their aggregate ownership percentage (on a fully-diluted basis) as if such issuance had not occurred. Likewise, as part of our restructuring efforts, if we issue notes or other debt instruments to any of our creditors, then we are required to issue additional warrants to each of the Investors representing the right to purchase that number of shares of common stock equal to the product of (x) 1.25 and (y) the original principal amount of such note or debt instrument.

Stockholder Meeting

The investment agreement requires us to hold a stockholder meeting for the purpose of seeking approval of an amendment to our certificate of incorporation increasing the number of authorized shares available for issuance to a number that would allow us to meet fully our obligations to issue shares of capital stock under the investment agreement. The inclusion of Proposal 2 in this proxy statement is a result of this requirement.

Agreements with Major Creditors

Teijin Limited

Teijin Limited, or Teijin, previously guaranteed our outstanding debt owed to UFJ Bank Limited (formerly known as Sanwa Bank Limited). On November 5, 2003, we defaulted on this debt and Teijin honored its guarantee by satisfying the obligation. Under the terms of Teijin's guarantee, we were obligated to immediately repay the amounts paid by Teijin. As part of the restructuring plan, we entered into an agreement with Teijin to satisfy Teijin's claim. The agreement included a payment schedule that spread the payments out over a period of four years until 2008. The obligations owed to Teijin will not accrue interest if paid according to the payment schedule. Teijin previously held a security interest in one of our production machines which they have released. We may dispose of the machine provided that we pay to Teijin the net proceeds of any disposition. Our obligations to Teijin are guaranteed by our subsidiary, Southwall Europe GmbH.

Judd Properties, LLC

We reached an agreement with Judd Properties, LLC, or Judd, to restructure our obligations under the lease for our executive offices and Palo Alto manufacturing facilities. We agreed to a payment schedule that extends our obligations and provides us with options to extend the lease. We further agreed to issue a warrant issuable for 4% of our capital stock on a fully diluted basis to be held in an escrow account pending our departure from the premises. Upon our departure, if we fail to restore the property in accordance with the original lease the warrant will be released to Judd. The warrant is exercisable for

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1,437,396 shares of our common stock at a nominal exercise price. The other terms of the warrant mirror the terms of the warrants issued to the Investors. Judd will be a party to the registration rights agreement described above and hold certain other registration rights with respect to the warrant shares. Because we did not have available enough authorized shares of common stock to issue upon exercise of the warrant, we were required to issue a letter of credit in the amount of \$1.0 million to be held by Judd as security for our obligations until such time as the requisite number of authorized shares are approved by our stockholders.

Portfolio Financial Servicing Company, Bank of America and Lehman Brothers

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On February 20, 2004, we entered into a settlement agreement with Portfolio Financial Servicing Company, Bank of America and Lehman Brothers, which extinguished a claim arising out of sale-leaseback agreements that we had entered into in connection with the acquisition of two of our production machines. As part of the settlement, we agreed to pay an aggregate of \$2.0 million plus interest over a period of six years. The settlement requires us to make an interest payment in 2004 and, beginning in 2005, to make quarterly principal and interest payments until 2010.

Richard A. Christina and Diane L. Christina Trust

On December 1, 2003, we reached an agreement with the Richard A. Christina and the Diane L. Christina Trust to modify the lease agreement for a building that we rent from the Trust in Palo Alto, California. Under the terms of the agreement, we agreed to pay the Trust \$300,000.

Greenwood and Son Real Estate Investments

On January 29, 2004, we reached an agreement with Greenwood and Son Real Estate Investments to restructure the remaining scheduled lease payments for our Tempe facility, following our decision to discontinue operations in our Tempe facility as of December 31. Under the terms of the settlement agreement, we agreed to pay the regular monthly rent of \$40,000 for the months of February and March 2004, and agreed to pay a cash buy-out of \$368,000 for the remaining obligations under the existing lease agreement. The cash buy-out will be paid ratably over a twelve-month starting on April 1, 2004.

Voluntary Delisting from Nasdaq

Effective March 26, 2004, we voluntarily de-listed from the Nasdaq National Market, and, after trading on the pink sheets, on May 6, 2004, we began trading on the Over-the-Counter Bulletin Board Market. Due to the structure of the transaction contemplated by the investment agreement, we were no longer in compliance with certain Nasdaq listing requirements. We felt that a voluntary delisting from Nasdaq and a move to the Over-the-Counter Bulletin Board Market would provide the best option to our shareholders by retaining liquidity in our common stock.

Board Recommendation and Required Stockholder Vote

The Board of Directors unanimously recommends that the stockholders vote FOR the proposal to increase the number of shares of common stock available for issuance under our charter.

The affirmative FOR vote of the holders of a majority of the outstanding shares of our common stock is required for approval of this proposal.

PROPOSAL 3
APPROVAL OF AMENDMENT TO
1997 STOCK INCENTIVE PLAN

Overview

On March 25, 2004, our Board of Directors adopted, subject to stockholder approval, an amendment to our 1997 Stock Incentive Plan, or the 1997 Plan, to increase the number of shares reserved for issuance and to eliminate the evergreen provisions that automatically on the first day of each year have increased the number of shares available for issuance, and directed that such amendment be submitted to the stockholders for their approval. The amendment to the 1997 Plan approved by the Board increased the number of shares authorized for issuance under the 1997 Plan from 2,150,000 to 6,150,000. The following summary of the 1997 Plan does not purport to be complete and is qualified in its entirety by reference to the full text of the 1997 Plan, which is attached as *Appendix A* to this proxy statement.

The 1997 Plan was adopted by the Board of Directors on March 20, 1997, and approved by the stockholders on May 21, 1997.

Purposes

The purpose of the 1997 Plan is to provide employees, directors and consultants with the opportunity to acquire a proprietary interest, or otherwise increase their proprietary interest, in us as an incentive to remain with us. The 1997 Plan contains four separate equity incentive programs: (i) a discretionary option grant program, (ii) a salary investment option grant program, (iii) a stock issuance program and (iv) a director fee option grant program. The principal features of these programs are described below.

Administration

The 1997 Plan is administered by the Board, which may delegate its powers under the 1997 Plan to one or more committees of the Board. With respect to the discretionary option grant, salary investment option grant and stock issuance programs, the administrator of the 1997 Plan has authority in its discretion to: (1) establish such rules and regulations as it may deem appropriate for proper administration of such programs and (2) construe and interpret the provisions of such programs and any options or stock issuances issued pursuant to such programs. More specifically, the administrator of 1997 Plan has authority to: (1) select employees, directors or consultants to whom options or stock may be granted; (2) determine the time or times such option or stock grants are to be made; (3) determine the number of shares covered by each grant and the consideration for such shares or options; (4) determine the status of the granted option as either an incentive option or a non-statutory option; (5) determine the time or times when each option is to become exercisable; (6) determine the vesting schedule (if any); and (7) determine the maximum term for which the option is to remain outstanding. Administration of the director fee option grant program is self-executing in accordance with the terms of such program and the administrator of the 1997 Plan does not have any discretionary functions with respect to option grants or stock issuances made under such program. While the administrator will make awards from time to time under the 1997 Plan, it has no current plans, proposals or arrangements to make any specific grants under the 1997 Plan, except for director fee option grants.

Shares Subject to the 1997 Plan

The stock subject to options and awards under the 1997 Plan is authorized but unissued shares of our common stock or shares of treasury common stock. Any shares subject to an option that for any reason expires or is terminated unexercised as to such shares shall be available for subsequent issuance under the 1997 Plan. Unvested shares issued under the 1997 Plan and subsequently canceled or repurchased by us pursuant to our repurchase rights under the 1997 Plan may again be the subject of an award under the 1997 Plan. Giving effect to the March 25, 2004 increase authorized by the Board of Directors, the maximum number of shares of common stock that may be issued under the 1997 Plan may not exceed

6,150,000 shares, subject to adjustment, as described below. On March 26, 2004, the closing sale price of our common stock was \$1.00 per share.

Limitations

The amendment authorized by the Board on March 25, 2004 increased the maximum number of option shares per calendar year that one individual may receive under the 1997 Plan from 200,000 to 1,000,000.

Eligibility

Nonstatutory stock options, or NSO s, and stock issuances may be granted to employees, directors and consultants. Incentive stock options, or ISO s, may be granted only to employees. Only employees are eligible to participate in the salary investment option grant program and only non-employee directors may participate in the director fee option grant program. As of March 28, 2004, approximately 150 employees, as well as our eight non-employee directors were eligible to participate in the 1997 Plan. As of April 6, 2004, 1,867,549 shares had been issued or reserved for issuance pursuant to outstanding options under the 1997 Plan.

Terms and Conditions of Options issued under the Discretionary Option Grant Program

Exercise Price. The exercise price for shares issued upon exercise of options will be determined by the administrator of the 1997 Plan. The exercise price of NSO s shall not be less than 85% of the fair market value of our common stock on the date the option is granted. The exercise price of ISO s may not be less than 100% of the fair market value of our common stock on the date the option is granted. The exercise price of ISO s granted to a 10% or greater stockholder may not be less than 110% of the fair market value of our common stock on the date of grant.

Form of Consideration. Subject to the documents evidencing the option, the 1997 Plan permits payment to be made by cash, check, promissory note of the participant, other shares of our common stock (with some restrictions), consideration received by us under a cashless exercise program implemented by us in connection with the 1997 Plan, or any combination thereof.

Term of Options. The term of an option may be no more than ten years from the date of grant, except that the term of an option granted to a 10% or greater stockholder may not exceed five years from the date of grant.

Effect of Termination of Service. No option may be exercised more than eighteen months following cessation of service for any reason, or such other period as determined by the administrator of the 1997 Plan and set forth in the documents evidencing the option. If, on the date of cessation of service, a participant is not fully vested, the shares covered by the unvested portion will revert to the 1997 Plan. If service is terminated for misconduct or unsatisfactory performance, all outstanding options shall terminate immediately and cease to be outstanding, unless the administrator of the 1997 Plan determines otherwise.

Repurchase Rights. If a participant ceases service while holding options exercisable for unvested shares, we have the right to repurchase, at the exercise price paid per share, any or all of those unvested shares. The terms of the repurchase right shall be established by the administrator of the 1997 Plan and set forth in the document evidencing such repurchase right.

Limits on Transferability. ISO s granted under the 1997 Plan may not be transferred during a participant s lifetime and will not be transferable other than by will or by the laws of descent and distribution following the participant s death. NSO s may be assigned during a participant s lifetime to members of the participant s family or to a trust established exclusively for such family members pursuant to the participant s estate plan.

Acceleration of Options/Termination of Repurchase Rights. The administrator of the 1997 Plan has the discretion to provide for the automatic acceleration of one or more outstanding options upon the

occurrence of a Corporate Transaction. For purposes of the 1997 Plan, a Corporate Transaction means (i) the sale, transfer or other disposition of all or substantially all of our assets in complete liquidation or dissolution or (ii) a merger or consolidation in which securities possessing more than 50% of the total combined voting power of our outstanding securities are transferred to a person or persons different from the persons holding those securities immediately prior to such transaction. An outstanding option may not accelerate, however, if and to the extent: (i) such option is, in connection with the Corporate Transaction, either to be assumed by the successor corporation (or parent thereof) or to be replaced with a comparable option to purchase shares of the capital stock of the successor corporation (or parent thereof), (ii) such option is to be replaced with a cash incentive program of the successor corporation which preserves the spread existing on the unvested option shares at the time of the Corporate Transaction and provides for subsequent payout in accordance with the same vesting schedule applicable to those option shares or (iii) the acceleration of such options is subject to other limitations imposed by the administrator of the 1997 Plan at the time of the option grant. Also upon a Corporate Transaction, our repurchase rights will terminate automatically unless assigned to the successor corporation.

The administrator of the 1997 Plan has the authority to provide for the automatic acceleration of one or more outstanding options under the discretionary option grant program in the event of a Change in Control or in the event the optionee's service terminates by reason of an involuntary termination within a designated period (not to exceed 18 months) following the effective date of any Corporate Transaction or Change in Control in which those options are assumed or replaced and do not otherwise accelerate. Any options so accelerated will remain exercisable until the earlier of (i) the expiration of the option term and (ii) the expiration of the one-year period after the effective date of the involuntary termination. In addition, the administrator of the 1997 Plan may provide that one or more of our repurchase rights with respect to shares held by the optionee at the time of such involuntary termination will immediately terminate, and the shares subject to those terminated repurchase rights will accordingly vest in full. For purposes of the 1997 Plan, a Change in Control means a change in ownership or control through either of the following transactions: (i) the acquisition, directly or indirectly by any person or related group of persons (other than us or a person that directly or indirectly controls, is controlled by, or is under common control with, us), of beneficial ownership of securities possessing more than 25% of the total combined voting power of our outstanding securities pursuant to a tender or exchange offer made directly to our stockholders which the Board of Directors does not recommend such stockholders accept, or (ii) a change in the composition of the Board over a period of 36 consecutive months or less such that the majority of the Board members ceases, by reason of one or more contested elections for Board membership, to be comprised of individuals who either (A) have been Board members continuously since the beginning of such period or (B) have been elected or nominated for election as Board members during such period by at least a majority of the Board members described in clause (A) who were still in office at the time the Board approved such election or nomination.

Other Provisions. The document evidencing each option grant may contain other terms, provisions and conditions not inconsistent with the 1997 Plan, as may be determined by the 1997 Plan administrator.

Terms and Conditions of Options issued under the Salary Investment Option Grant Program

Right to Participate. The administrator of the 1997 Plan has complete discretion in determining whether the salary investment option grant program is to be in effect for a given calendar year and in selecting the employees eligible to participate in the program. As a condition to such participation, each selected individual who elects to participate must, prior to the start of each calendar year of participation, file an irrevocable authorization directing us to reduce his or her base salary for that calendar year by an amount not less than \$10,000 nor more than \$50,000. To the extent the administrator of the plan approves the salary reduction authorization, the affected individual will be granted NSOs under the program. Except as described below, the terms of each option granted under the salary investment option grant

program are substantially the same as the terms in effect for option grants made under the discretionary option grant program.

Exercise Price. The exercise price of all NSO s issued pursuant to the salary investment option grant program is one-third of the fair market value of our common stock on the date of the option grant.

Number of Option Shares. The number of option shares will be determined by dividing the total dollar amount of the approved reduction in the participant s base salary by two-thirds of the fair market value per share of our common stock on the option grant date.

Exercise and Term of Options. Provided the participant continues in service, the option shares will become exercisable in a series of 12 successive equal monthly installments upon the participant s completion of each calendar month of service in the calendar year for which the salary reduction is in effect. The term of an option issued pursuant to this program may be no more than 10 years from the date of grant.

Effect of Termination of Service. If the participant ceases service for any reason while holding any options under the salary investment option grant program, each option that is exercisable at the time of such cessation of service shall remain exercisable until the earlier of (i) the expiration of the ten year option term or (ii) the expiration of the three year period measured from the date of cessation of service. If, on the date of cessation of service, a participant is not fully vested, the shares covered by the unvested portion will revert to the 1997 Plan.

Acceleration of Options/Termination of Repurchase Rights. Upon a Corporate Transaction or a Change in Control while the participant remains in service, each outstanding option held by a participant under the salary investment option grant program will automatically accelerate so that each such option will become fully exercisable with respect to the total number of shares of common stock at the time subject to such option and may be exercised for any or all of those shares as fully vested shares of common stock. Each such outstanding option will remain exercisable for the fully vested shares until the earlier of (i) the expiration of the 10 year option term or (ii) the expiration of the 3 year period measured from the date of the participant s cessation of service.

The administrator of the 1997 Plan may also provide that, upon the occurrence of a Hostile Take-Over, the participant will have a 30 day period in which to surrender to us each of his or her outstanding option grants in return for a cash distribution in an amount equal to the excess of (i) the Take-Over Price of the shares of common stock at the time subject to each surrendered option (whether or not the participant is vested in those shares) over (ii) the aggregate exercise price payable for such shares. For purposes of the 1997 Plan, Hostile Take-Over means the acquisition, directly or indirectly, by any person or related group of persons (other than us or a person that directly or indirectly controls, is controlled by, or is under common control with, us) of beneficial ownership of securities possessing more than 50% of the total combined voting power of our outstanding securities pursuant to a tender offer or exchange offer made directly to our stockholders which the Board does not recommend the stockholders accept. Take-Over Price means the greater of (i) the fair market value per share of our common stock on the date the option is surrendered to us in connection with a Hostile Take-Over or (ii) the highest reported price per share of our common stock paid by the tender offeror in effecting such Hostile Take-Over. However, if the surrendered option is an ISO, the Take-Over Price shall not exceed the clause (i) price per share.

Terms and Conditions of Stock issued under the Stock Issuance Program

Rights to Issuance. Shares of our common stock may be issued under the stock issuance program through direct and immediate issuances without any intervening option grants. Each stock issuance under the stock issuance program shall be evidenced by a stock issuance agreement.

Purchase Price. The purchase price for shares issued under the stock issuance program will be determined by the administrator of the 1997 Plan, but may not be less than 100% of the fair market value of our common stock on the date the stock is issued.

Form of Consideration. The 1997 Plan permits payment to be made by cash, check, promissory note of the participant or past services rendered to us (or any parent or subsidiary). The administrator may grant shares to participants based on the attainment of specific financial performance targets for the Company.

Vesting. In the discretion of the administrator of the 1997 Plan, shares issued under the stock issuance program may be fully and immediately vested upon issuance, or may vest in one or more installments over the participant's period of service or upon attainment of performance goals. The recipient of shares issued under the stock issuance program will have full stockholder rights with respect to any shares issued, whether or not the participant's interest in those shares is vested. If the participant ceases to remain in service while holding one or more unvested shares of our common stock issued under the stock issuance program, or should performance objectives not be attained, the shares shall immediately be surrendered to us for cancellation unless the administrator of the 1997 Plan determines otherwise.

Acceleration of Vesting/Termination of Repurchase Rights. In the event of any Corporate Transaction, all outstanding repurchase rights under the stock issuance program will terminate automatically, and all of the shares subject to such terminated rights will immediately vest in full, except to the extent (i) those repurchase rights are to be assigned to the successor corporation in connection with the Corporate Transaction or (ii) such accelerated vesting is precluded by limitations imposed in the stock issuance agreement. Notwithstanding the above, the administrator of the 1997 Plan has the discretionary authority, exercisable either at the time the unvested shares are issued or any time while the repurchase rights remain outstanding, to provide that those rights shall automatically terminate in whole or in part, and the shares subject to those terminated rights will immediately vest, in the event of (i) a Corporate Transaction, whether or not those repurchase rights are to be assigned to the successor corporation in connection with such Corporate Transaction, (ii) a Change in Control or (iii) an involuntary termination of the participant within a designated period (not to exceed 18 months) following the Corporate Transaction or Change in Control.

Terms and Conditions of Options Issued under the Director Fee Option Grant Program

Right to Participate. Each non-employee Board member has the right to participate in the director fee option grant program. Under such program, a non-employee Board member may apply all or a portion of the annual retainer fee, otherwise payable in cash, to the acquisition of option grants. The non-employee Board member must make the election prior to the first day of the calendar year for which the annual retainer fee which is subject to the election is otherwise payable. Each option granted under the director fee option grant program will be an NSO. Except as described below, the terms of each option granted under the director fee option grant program are substantially the same as the terms in effect for option grants made under the discretionary option grant program.

Exercise Price. The exercise price of all NSO's issued pursuant to the director fee option grant program is one-third of the fair market value of our common stock on the date of the option grant.

Number of Option Shares. The number of option shares will be determined by dividing the portion of the annual retainer fee subject to the participant's election by two-thirds of the fair market value per share of our common stock on the option grant date.

Exercise and Term of Options. Fifty percent of the option shares will become exercisable upon the participant's completion of 6 months of Board service in the calendar year for which his or her election under the director fee option grant program is in effect, and the balance of the option shares will become exercisable in a series of 6 equal monthly installments upon the participant's completion of each additional

month of Board service during the calendar year. The term of an option issued pursuant to this program may be no more than 10 years from the date of grant.

Effect of Termination of Service. If the participant ceases Board service for any reason (other than death or permanent disability) while holding any options under the director fee option grant program, each option that is exercisable at the time of such cessation of Board service shall remain exercisable until the earlier of (i) the expiration of the ten year option term or (ii) the expiration of the three year period measured from the date of cessation of Board service. If, on the date of cessation of service, a participant's options are not fully vested, the shares covered by the unvested portion will revert to the 1997 Plan.

Death or Permanent Disability. If the participant ceases Board service as a result of death or permanent disability, each option held by the participant under the director fee option grant program will immediately become exercisable for all of the shares of our common stock at the time subject to the option, and the option may be exercised for any or all of those shares as fully vested shares until the earlier of (i) the expiration of the ten year option term or (ii) the expiration of the three year period measured from the date of such cessation of Board service. If the participant dies after cessation of Board service but while holding one or more options under the director fee option grant program, each such option may be exercised, for any or all of the shares for which the option is exercisable at the time of the participant's cessation of Board service, by the personal representative of the participant's estate or by the person or persons to whom the option is transferred pursuant to the participant's will or in accordance with the laws of descent and distribution. Such right will lapse, and the option will terminate, upon the earlier of (i) the expiration of the ten-year option term or (ii) the three-year period measured from the date of the participant's cessation of Board service.

Acceleration of Options/Termination of Repurchase Rights. Upon a Corporate Transaction or a Change in Control while the participant remains a Board member, each outstanding option held by such participant under the director fee option grant program will automatically accelerate so that each such option will become fully exercisable with respect to the total number of shares of common stock at the time subject to such option and may be exercised for any or all of those shares as fully vested shares of our common stock. Each such outstanding option will remain exercisable for the fully vested shares until the earlier of (i) the expiration of the ten-year option term or (ii) the expiration of the three-year period measured from the date of the participant's cessation of service.

In the event of a Hostile Take-Over, the participant will have a 30 day period in which to surrender to us each of his or her outstanding option grants in return for a cash distribution in an amount equal to the excess of (i) the Take-Over Price of the shares of common stock at the time subject to each surrendered option (whether or not the participant is vested in those shares) over (ii) the aggregate exercise price payable for such shares.

Adjustments

Changes in Capitalization. In the event of a stock split, stock dividend, recapitalization, combination of shares, exchange of shares or other change affecting the outstanding common stock as a class without our receipt of consideration, appropriate adjustment shall be made to (1) the number and class of securities available under the 1997 Plan, (2) the per-participant limit, (3) the number and class of securities and exercise price per share subject to each outstanding award, and (4) the terms of each other outstanding option shall be appropriately adjusted in a manner which shall preclude the enlargement or dilution of rights and benefits under such options.

Amendment and Termination

Our Board may at any time amend or modify the 1997 Plan in any or all respects. The Board will obtain stockholder approval of any amendment to the 1997 Plan to the extent necessary and desirable to comply with applicable laws. No amendment or modification shall adversely affect the rights and

obligations with respect to stock options or unvested stock issuances of any participant, unless the participant consents to such amendment or modification. The 1997 Plan will terminate upon the earlier of (i) May 21, 2007 or (ii) the termination of all outstanding options.

2003 Option Grants Under the 1997 Plan

The following table set forth the number of outstanding options granted during 2003 under the 1997 Plan to the specified individuals and groups:

Name	Number of Options
Thomas G. Hood	60,000
Wolfgang Heinze	10,000
Michael E. Seifert	25,000
Sicco W.T. Westra	15,000
Bruce M. Lairson	25,000
All current executive officers as a group (six persons)	200,000
All employees who were not executive officers as a group (143 persons)	35,000

Federal Income Tax Consequences

ISOs A participant who receives an ISO will recognize no taxable income for regular federal income tax purposes upon either the grant or the exercise of such ISO. However, when a participant exercises an ISO, the difference between the fair market value of the shares purchased and the option price of those shares will be includable in determining the participant's alternative minimum taxable income.

If the shares are retained by the participant for at least one year from the date of exercise and two years from the date of grant of the options, gain will be taxable to the participant upon sale of the shares as a long-term capital gain. In general, the adjusted basis for the shares acquired upon exercise will be the option price paid with respect to such exercise. We will not be entitled to a tax deduction arising from the exercise of an ISO if the employee qualifies for such long-term capital gain treatment.

NSOs A participant will not recognize taxable income for federal income tax purposes at the time an NSO is granted. However, the participant will recognize compensation taxable as ordinary income at the time of exercise for all shares that are not subject to a substantial risk of forfeiture. The amount of such compensation will be the difference between the option price and the fair market value of the shares on the date of exercise of the option. We will be entitled to a deduction for federal income tax purposes at the same time and in the same amount as the participant is deemed to have recognized compensation income with respect to shares received upon exercise of the NSO. The participant's basis in the shares will be adjusted by adding the amount so recognized as compensation to the purchase price paid by the participant for the shares.

The participant will recognize gain or loss when he or she disposes of shares obtained upon exercise of an NSO in an amount equal to the difference between the selling price and the participant's tax basis in such shares. Such gain or loss will be treated as long-term or short-term capital gain or loss, depending upon the holding period.

The Board of Directors unanimously recommends that you vote FOR the amendment of our 1997 Plan, and proxies solicited by the Board will be voted in favor of the amendment of our 1997 Plan unless a stockholder has indicated otherwise on the proxy.

Overview

Our 1998 Stock Plan for Employees and Consultants, or the 1998 Plan, was adopted by our Board of Directors in August, 1998. On March 25, 2004, our Board of Directors adopted an amendment to our 1998 Plan to increase the number of shares reserved for issuance and to eliminate the evergreen provisions that automatically on the first day of each year have increased the number of shares available for issuance, and directed that such amendment be submitted to the stockholders for their approval. The amendment to the 1998 Plan approved by the Board increased the number of shares authorized for issuance under the 1998 Plan from 1,150,000 to 2,400,000. The following summary of the 1998 Plan does not purport to be complete and is qualified in its entirety by reference to the full text of the 1998 Plan, which is attached as *Appendix B* to this proxy statement. The 1998 Plan has not previously been approved by our stockholders.

Purposes

The purpose of the 1998 Plan is to provide non-officer employees who are not members of the Board and consultants with the opportunity to acquire a proprietary interest, or otherwise increase their proprietary interest, in us as an incentive to remain with us. The 1998 Plan contains two separate equity incentive programs: (i) a discretionary option grant program and (ii) a stock issuance program. The principal features of these programs are described below.

Administration

The 1998 Plan is administered by the Board, which may delegate its powers under the 1998 Plan to one or more committees of the Board. The administrator of the 1998 Plan has authority in its discretion to: (1) establish such rules and regulations as it may deem appropriate for proper administration of the discretionary option grant program and stock issuance program and (2) construe and interpret the provisions of the programs and any options or stock issuances issued pursuant to such programs. More specifically, the administrator of the 1998 Plan has authority to: (1) select non-officer employees who are not members of the Board and consultants to whom options or stock may be granted; (2) determine the time or times such option or stock grants are to be made; (3) determine the number of shares to be covered by each grant and the consideration for such shares or options; (4) determine the time or times when each option is to become exercisable; (5) determine the vesting schedule (if any); and (6) determine the maximum term for which the option is to remain outstanding. While the administrator will make awards from time to time under the 1998 Plan, it has no current plans, proposals or arrangements to make any specific grants under the Plan.

Shares Subject to the 1998 Plan

The stock subject to options and awards under the 1998 Plan is authorized but unissued shares of our common stock or shares of treasury common stock. Any shares subject to an option that for any reason expires or is terminated unexercised as to such shares shall be available for subsequent issuance under the 1998 Plan. Unvested shares issued under the 1998 Plan and subsequently canceled or repurchased by us pursuant to our repurchase rights under the 1998 Plan may again be the subject of an award under the 1998 Plan. After giving effect to the March 25, 2004 increase authorized by the Board of Directors, the maximum number of shares of common stock that may be issued under the 1998 Plan may not exceed 2,250,000 shares, subject to adjustment, as described below. On March 26, 2004, the closing sale price of our common stock was \$1.00 per share.

Limitations

The amendment authorized by the Board on March 25, 2004, increased the maximum number of option shares per calendar year that one individual may receive under the 1998 Plan from 50,000 to 100,000.

Eligibility

Nonstatutory stock options, or NSO's, and stock issuances may be granted to employees who are not officers or members of the Board, consultants and other independent advisors.

Terms and Conditions of Options

Exercise Price. The exercise price for shares issued upon exercise of options will be determined by the administrator of the 1998 Plan but may not be less than 85% of the fair market value of our common stock on the date the option is granted.

Form of Consideration. Subject to the documents evidencing the option, the 1998 Plan permits payment to be made by cash, check, promissory note of the participant, other shares of our common stock (with some restrictions), consideration received by us under a cashless exercise program implemented by us in connection with the 1998 Plan, or any combination thereof.

Term of Options. The term of an option may be no more than ten years from the date of grant.

Effect of Termination of Service. No option may be exercised more than eighteen months following cessation of service for any reason, or such other period as determined by the administrator of the 1998 Plan and set forth in the documents evidencing the option. If, on the date of cessation of service, a participant is not fully vested, the shares covered by the unvested portion will revert to the 1998 Plan. If service is terminated for misconduct or unsatisfactory performance, all outstanding options shall terminate immediately and cease to be outstanding, unless the administrator of the 1998 Plan determines otherwise.

Repurchase Rights. If a participant ceases service while holding options exercisable for unvested shares, we have the right to repurchase, at the exercise price paid per share, any or all of those unvested shares. The terms of the repurchase right shall be established by the administrator of the 1998 Plan and set forth in the document evidencing such repurchase right.

Limits on Transferability. NSO's may be assigned during a participant's lifetime to members of the participant's family or to a trust established exclusively for such family members pursuant to the participant's estate plan.

Acceleration of Options/Termination of Repurchase Rights. In the event of a Corporate Transaction, the vesting of each option held by a non-officer employee shall automatically accelerate unless it is expressly assumed or replaced with a comparable option or cash incentive program by the successor corporation (or parent thereof). For purposes of the 1998 Plan, a Corporate Transaction means (i) the sale, transfer or other disposition of all or substantially all of our assets in complete liquidation or dissolution or (ii) a merger or consolidation in which securities possessing more than 50% of the total combined voting power of our outstanding securities are transferred to a person or persons different from the persons holding those securities immediately prior to such transaction. An outstanding option may not accelerate, however, if and to the extent: (i) such option is, in connection with the Corporate Transaction, either to be assumed by the successor corporation (or parent thereof) or to be replaced with a comparable option to purchase shares of the capital stock of the successor corporation (or parent thereof), (ii) such option is to be replaced with a cash incentive program of the successor corporation which preserves the spread existing on the unvested option shares at the time of the Corporate Transaction and provides for subsequent payout in accordance with the same vesting

schedule applicable to those option shares or

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(iii) the acceleration of such options is subject to other limitations imposed by the administrator of the 1998 Plan at the time of the option grant. Also upon a Corporate Transaction, our repurchase rights will terminate automatically unless assigned to the successor corporation.

The administrator of the 1998 Plan has the authority to provide for the automatic acceleration of one or more outstanding options in the event of a Change in Control or in the event the optionee's service terminates by reason of an involuntary termination within a designated period (not to exceed 18 months) following the effective date of any Corporate Transaction or Change in Control. In addition, the administrator of the 1998 Plan may provide that one or more of our repurchase rights with respect to shares held by the optionee at the time of such involuntary termination will immediately terminate, and the shares subject to those terminated repurchase rights will accordingly vest in full. For purposes of the 1998 Plan, a Change in Control means a change in ownership or control through either of the following transactions: (i) the acquisition, directly or indirectly by any person or related group of persons (other than us or a person that directly or indirectly controls, is controlled by, or is under common control with, us), of beneficial ownership of securities possessing more than 25% percent of the total combined voting power of our outstanding securities pursuant to a tender or exchange offer made directly to our stockholders which the Board of Directors does not recommend such stockholders accept, or (ii) a change in the composition of the Board over a period of 36 consecutive months or less such that the majority of the Board members ceases, by reason of one or more contested elections for Board membership, to be comprised of individuals who either (a) have been Board members continuously since the beginning of such period or (b) have been elected or nominated for election as Board members during such period by at least a majority of the Board members described in clause (a) who were still in office at the time the Board approved such election or nomination.

Other Provisions. The stock option agreement for each option grant may contain other terms, provisions and conditions not inconsistent with the 1998 Plan, as may be determined by the 1998 Plan administrator.

Terms and Conditions Stock Issued under the Stock Issuance Program

Rights to Issuance. Shares of our common stock may be issued under the stock issuance program through direct and immediate issuances without any intervening option grants. Each stock issuance under the stock issuance program shall be evidenced by a stock issuance agreement.

Purchase Price. The purchase price for shares issued under the stock issuance program will be determined by the administrator of the 1998 Plan, but may not be less than 100% of the fair market value of our common stock on the date the stock is issued.

Form of Consideration. The 1998 Plan permits payment to be made by cash, check, promissory note of the participant or past services rendered to us (or any parent or subsidiary).

Vesting. In the discretion of the administrator of the 1998 Plan, shares issued under the stock issuance program may be fully and immediately vested upon issuance, or may vest in one or more installments over the participant's period of service or upon attainment of performance goals. The recipient of shares issued under the stock issuance program will have full stockholder rights with respect to any shares issued, whether or not the participant's interest in those shares is vested. If the participant ceases to remain in service while holding one or more unvested shares of our common stock issued under the stock issuance program, or should performance objectives not be attained, the shares shall immediately be surrendered to us for cancellation unless the administrator of the 1998 Plan determines otherwise.

Acceleration of Vesting/Termination of Repurchase Right