SECURITIES AND EXCHANGE COMMISSION

FORM 10-Q

Quarterly report pursuant to sections 13 or 15(d)

Filing Date: **2001-11-14** | Period of Report: **2001-09-30**
SEC Accession No. 0000912057-01-539433

(HTML Version on secdatabase.com)

FILER

NEON COMMUNICATIONS INC

CIK:**1116086**| IRS No.: **043523408** | State of Incorp.:**DE** | Fiscal Year End: **1231**
Type: **10-Q** | Act: **34** | File No.: **333-38600** | Film No.: **1786313**
SIC: **4813** Telephone communications (no radiotelephone)

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

/x/ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2001

OR

/ / **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**

For the transition period from to _______ to _______

Commission File Number	Exact Name of Registrant as Specified in Its Charter; State of Incorporation; Address, Including Zip Code, and Telephone Number, Including Area Code, of Registrant's Principal Executive Offices	IRS Employer Identification Number
000-31531	NEON Communications, Inc. (a Delaware corporation) 2200 West Park Drive Westborough, Massachusetts 01581 (508) 616-7800	04-3523408

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:
NEON Communications, Inc.–Common Stock, Par Value $0.01 Per Share

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

At November 1, 2001 there were 21,335,061 shares of NEON Communications, Inc. common stock outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NEON COMMUNICATIONS, INC.
Condensed Consolidated Balance Sheets

(Unaudited)

	December 31, 2000	September 30, 2001
Assets		
Current Assets:		
Cash and cash equivalents	$ 20,650,158	$ 10,640,005
Short-term investments	–	2,992,849
Short-term restricted investments	24,452,374	14,092,490
Accounts receivable, net	2,725,732	5,851,060
Prepaid expenses and other current assets	413,764	1,007,196
Total current assets	48,242,028	34,583,600
Property and Equipment, net	161,425,167	185,115,500
Restricted Investments	10,851,258	–

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Intangible and Other Assets, net	61,418,238	57,876,569
	$ 281,936,691	$ 277,575,669

Liabilities and Stockholders' Equity (Deficit)

Current Liabilities:		
Accounts payable	$ 21,559,425	$ 6,740,174
Accounts payable−Communications network	11,874,368	3,633,766
Accrued expenses	13,526,077	10,793,518
Current portion of long-term obligations	−	20,865,154
Accrued right-of-way fees, related party	679,531	679,531
Deferred revenue	735,105	1,498,578
Total current liabilities	48,374,506	44,210,721
Deferred revenue, net of current portion	3,989,670	14,266,905
Long-term obligations, net of current portion	193,650,642	221,634,237
Contingencies (Note 7)		
Stockholders' Equity (Deficit):		
Unrestricted Common stock, $0.01 par value−		
Authorized−60,000,000 shares; Issued and outstanding−18,753,870 and 19,948,089 shares at December 31, 2000 and September 30, 2001, respectively	187,539	199,481
Restricted common stock (Note 2)	25,804	13,870
Subscription receivable (Note 2)	(167,431,217)	(105,912,780)
Additional paid-in capital	289,445,281	290,317,239
Accumulated deficit	(86,305,534)	(187,154,004)
Total stockholders' equity (deficit)	35,921,873	(2,536,194)
	$ 281,936,691	$ 277,575,669

The accompanying notes are an integral part of these condensed consolidated financial statements.

NEON COMMUNICATIONS, INC.

Condensed Consolidated Statements of Operations

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2000	**2001**	**2000**	**2001**
Revenues:				

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Network services	$ 3,136,374	$ 6,342,499	$ 7,109,486	$ 16,856,612
Other services	544,128	748,263	1,524,223	2,006,465
Total revenues	3,680,502	7,090,762	8,633,709	18,863,077
Expenses:				
Cost of revenues	2,745,150	4,143,789	7,387,915	12,487,472
Selling, general and administrative	4,850,600	5,833,388	10,413,889	19,729,425
Writedown of subscription receivable (Note 2)	–	60,000,000	–	60,000,000
Depreciation and amortization	3,078,564	4,984,891	8,419,636	13,435,914
Total expenses	10,674,314	74,962,068	26,221,440	105,652,811
Loss from operations	(6,993,812)	(67,871,306)	(17,587,731)	(86,789,734)
Other Income (Expense):				
Interest and other income	1,103,195	533,984	3,996,640	3,135,146
Interest expense	(5,287,652)	(7,022,037)	(15,976,127)	(17,193,882)
Total other expense, net	(4,184,457)	(6,488,053)	(11,979,487)	(14,058,736)
Net Loss	$ (11,178,269)	$ (74,359,359)	$ (29,567,218)	$ (100,848,470)
Basic and Diluted Loss per Share	$(0.66)	$(3.83)	$(1.77)	$(5.31)
Basic and Diluted Weighted Average Shares Outstanding	17,056,292	19,434,781	16,729,330	18,981,282

The accompanying notes are an integral part of these condensed consolidated financial statements.

NEON COMMUNICATIONS, INC.

Condensed Consolidated Statements of Cash Flows

(Unaudited)

	Nine Months Ended September 30,	
	2000	**2001**
Cash Flows from Operating Activities:		
Net loss	$ (29,567,218)	$ (100,848,470)
Adjustments to reconcile net loss to net cash used in operating activities –		

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Writedown of subscription receivable	–	60,000,000
Depreciation and amortization	8,419,636	13,435,914
Amortization of deferred financing and interest costs	469,983	1,268,998
Gain on sale of property and equipment	–	(1,514,555)
Changes in assets and liabilities–		
Accounts receivable	(623,995)	(3,125,328)
Prepaid expenses and other current assets	(431,102)	(593,432)
Accounts payable	(1,461,454)	9,040,997
Accrued expenses	(5,789,342)	(2,732,559)
Deferred revenue	1,426,598	11,040,708
Net cash used in operating activities	(27,556,894)	(14,027,727)
Cash Flows from Investing Activities:		
Sales (purchases) of short-term investments, net	66,803,311	(2,992,849)
Proceeds from sale of property and equipment	–	4,000,000
Purchases of property and equipment	(53,577,618)	(35,715,267)
Increase in intangible and other assets	(523,653)	(2,042,288)
Net cash provided by (used in) investing activities	12,702,040	(36,750,404)
Cash Flows from Financing Activities:		
(Decrease) increase in accounts payable–communications network	18,869,586	(2,402,317)
Decrease in restricted cash and investments	19,329,789	21,211,142
Proceeds from issuance of convertible debt	–	26,500,000
Payment of long-term obligations	–	(5,781,250)
Proceeds from issuance of common and restricted common stock, net	8,672,561	–
Proceeds from subscription receivable	–	1,518,437
Payment of common stock issuance costs	–	(285,351)
Proceeds from exercise of common stock options	3,533,453	7,317
Net cash provided by financing activities	50,405,389	40,767,978
Net Increase (Decrease) in Cash and Cash Equivalents	35,550,535	(10,010,153)
Cash and Cash Equivalents, beginning of period	4,768,389	20,650,158
Cash and Cash Equivalents, end of period	40,318,924	10,640,005
Supplemental Disclosure of Cash Flow information:		
Cash paid during the period for–		
Interest	$ 23,052,502	$ 24,174,973
Taxes	$ –	$ 231,265
Supplemental Disclosure of Non-Cash Financing Information:		
Beneficial conversion in Exelon transaction (Note 4(b))	$ –	$ 1,150,000
Increase (decrease) in subscription receivable	$ 167,431,217	$ (60,000,000)
Issuance of note payable to Nortel Networks (Note 4(c))	$ –	$ 46,250,000

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NEON COMMUNICATIONS, INC.
Notes to Condensed Consolidated Financial Statements

(Unaudited)

(1) Operations and Reorganization

NEON Communications, Inc. (the "Company" or "NEON") and its subsidiaries are engaged in the ownership, management, operation and installation of fiber optic telecommunication networks. NEON is a leading provider of advanced optical networking solutions and services in the Northeast and Mid-Atlantic regions of the United States.

To date, the Company has recorded revenues principally from network transport and related services contracts and has incurred cumulative operating losses of approximately $187,200,000, including the effect of a one-time non-cash charge of $60,000,000 described in Note 2. The market for fiber optic telecommunications in which the Company operates is changing rapidly due to technological advancements, the introduction of new products and services, the increasing demands placed on equipment in worldwide telecommunications networks and the demand for telecommunications capacity compared to the supply currently available.

In September 2000, the Company completed its second reorganization, under the terms of which NEON Communications, Inc. became the parent holding company of Northeast Optic Network, Inc. At the same time, Northeast Optic Network, Inc. changed its name to NEON Optica, Inc. The common stock of NEON Communications, Inc. is traded on the Nasdaq National Market under the symbol "NOPT", with NEON Optica, Inc., the operating entity, as a wholly owned subsidiary of NEON Communications, Inc. The names were changed to reflect the fact that NEON is now doing business in both the Northeast and the Mid-Atlantic regions.

(2) Network Connectivity Purchases in Exchange for Stock

On September 14, 2000, the Company closed an agreement with Consolidated Edison Communications, Inc. ("CEC") under which CEC agreed to grant the Company an indefeasible right to use ("IRU") fiber optic facilities on the CEC network to provide network transport and carrier services in its service area, which includes New York City and Westchester County, New York. At the same time, CEC also agreed to provide connectivity from NEON's backbone system to its local distribution facilities in its service area. This communications network will operate under the NEON brand, expanding NEON's network into and around New York. The term of the IRU granted under the CEC agreement is for no less than 25 years. In addition to the IRUs and intangible assets, CEC has also agreed to contribute to the Company cash totaling $11,300,000 over the period from September 14, 2000 to April 15, 2005 for the build-out of local points of presence ("POP") and the related optronic equipment and for the cost of POP rental, POP operating expenses, optronic equipment maintenance and sales and marketing expenses. As part of the agreement, the Company has issued 2,476,735 shares of common stock to CEC, of which 56% was restricted as of September 30, 2001, with such restrictions to lapse incrementally upon the completion of certain milestones over the terms of the agreement, as detailed in the contract with CEC. This transaction resulted in CEC owning approximately 10.5% of NEON's fully diluted common stock. Pursuant to a stockholders' agreement entered into among the Company, CEC, Exelon Enterprises Management, Inc. ("Exelon"), and a subsidiary of Northeast Utilities, CEC has nominated a member of the Company's Board of Directors. In connection with this transaction, the Company has recorded a subscription receivable on the accompanying consolidated balance sheet for the value of these assets, based upon an appraisal of the value of the tangible and intangible assets received in consideration for the stock provided under this agreement. As network assets are received under this agreement, the related subscription receivable amount will be transferred to fixed and intangible assets. The addition of these tangible and intangible assets will result in

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significant depreciation and amortization expense and an increase in the Company's net loss per share over the terms of the IRU granted under this agreement.

On September 14, 2000, the Company also closed a similar agreement with Exelon. Under the initial agreement with Exelon, the Company issued 2,131,143 shares of common and restricted common stock to Exelon, which resulted in Exelon owning approximately 9.1% of NEON's fully diluted common stock, and received cash totaling approximately $3,300,000 from Exelon. Exelon also entered into a stockholders' agreement among the Company, CEC, Exelon and a subsidiary of Northeast Utilities, whereby Exelon has nominated a member of the Company's Board of Directors. On August 10, 2001, the Company closed financing of $11,500,000 in the form of an 18% subordinated convertible note ("Exelon Convertible Note") with Exelon (see Note 4(b)) and modified the September 2000 agreement. The Exelon Convertible Note purchase agreement provides for an additional $10,000,000 from Exelon, payable either in cash or forgiveness of indebtedness represented by the Exelon Convertible Note on or before April 2002 in lieu of providing the IRU, services and other cash proceeds required under the September 2000 agreement with Exelon. Pursuant to the Exelon Convertible Note purchase agreement, all restrictions on the common stock issued to Exelon in September 2000 were released. In connection with the September 2000 agreement, the Company recorded a subscription receivable on the accompanying consolidated balance sheet for the value of the assets, as determined based on an independent appraisal of the value of the tangible and intangible assets to be received. Upon closing the Exelon Convertible Note, the Company recorded a one-time, non-cash charge to operations of $60,000,000 to writedown the subscription receivable related to the Exelon transaction.

(3) Significant Accounting Policies

The accompanying consolidated financial statements reflect the application of certain accounting policies as described below and elsewhere in these notes to consolidated financial statements.

(a) Principles of Consolidation

The accompanying consolidated financial statements include the results of operations of NEON Communications, Inc., its wholly owned subsidiary, NEON Optica, Inc. ("NEON Optica") and NEON Optica's wholly owned subsidiaries. All significant intercompany transactions and balances have been eliminated in consolidation.

(b) Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission, and reflect all adjustments, consisting of only normal recurring adjustments, which, in the opinion of management, are necessary for a fair statement of the results of the interim periods presented. These financial statements do not include disclosures associated with the annual financial statements and, accordingly, should be read in conjunction with the attached Management's Discussion and Analysis of Financial Condition and Results of Operations and the financial statements and footnotes for the year ended December 31, 2000 included in the Company's Form 10-K.

(c) Management Estimates

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

(d) Revenue Recognition

The services the Company provides include short-term leases of lit fiber (fixed amounts of capacity on fiber optic transmission lines that use optronics equipment installed by the Company) and longer-term leases of dark fiber (fiber optic transmission lines leased without

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optronics equipment installed by the Company) at fixed-cost pricing over multi-year terms. Revenues on telecommunications network services are recognized ratably over the term of the applicable lease agreements with customers, which range from one to 20 years. Amounts billed in advance of the service provided are recorded as deferred revenue (see Note 3(e)). The Company also leases space to customers at its collocation facilities. Other service revenues includes these collocation service revenues as well as revenues from nonrecurring installation charges and design, engineering and construction services.

In December 1999, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin ("SAB") No. 101, *Revenue Recognition*, which provides guidance on applying generally accepted accounting principles to recognition of revenues. The Company adopted SAB No. 101 in the fourth quarter of 2000. Under the guidance of SAB No. 101, the Company recognizes revenues from nonrecurring installation charges and design, engineering and construction services ratably over the multi-year network services terms to which the nonrecurring charges relate. Prior to the issuance of SAB No. 101, revenues for these nonrecurring services were generally recognized as services were performed because the Company had no further obligations. The Company adopted this new accounting guidance as of January 1, 2000 and all periods presented have been restated to reflect the effects of SAB No. 101.

The Company has contracts with customers that provide service-level commitments, which may obligate the Company to provide credits against billings if service is interrupted or does not meet the customer's operating parameters. These amounts are accounted for in cost of sales. To date, credits granted under these arrangements have not been material.

(e) Deferred Revenue

Deferred revenue represents prepayments on dark fiber optic cable leases and amounts related to nonrecurring fees to be recognized over the terms of the customer fiber optic lease arrangements to which they relate in accordance with SAB No. 101. Lease payments are structured as either prepayments or monthly recurring charges. Prepayments are accounted for as deferred revenue and recognized over the term of the respective customer fiber optic lease agreement.

(f) Comprehensive Income (Loss)

Statement of Financial Accounting Standards ("SFAS") No. 130, *Reporting Comprehensive Income*, requires disclosure of all components of comprehensive income (loss) on an annual and interim basis. Comprehensive income (loss) is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. Comprehensive net loss is the same as reported net loss for all periods presented.

(g) Loss per Share

In accordance with SFAS No. 128, Earnings per Share, basic and diluted loss per share were computed by dividing net loss by the weighted average number of common shares outstanding. Diluted net loss per share in the three and nine months ended September 30, 2001 excludes 1,386,972 shares of restricted common stock and 2,671,075 and 2,562,600 shares issuable from the assumed exercise of stock options, respectively, as their effect would be antidilutive. Diluted net loss per share in the three and nine months ended September 30, 2000 excludes 2,580,412 shares of restricted stock and 1,342,740 and 1,417,705 shares issuable from the assumed exercise of stock options, respectively, as their effect would be antidilutive.

(h) Reclassifications

Certain prior-period amounts have been reclassified to conform to the current period presentation.

(i) New Accounting Standards

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In July 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 141, *Business Combinations*. SFAS No. 141 requires all business combinations initiated after June 30, 2001 to be accounted for using the purchase method. This statement is effective for all business combinations initiated after June 30, 2001. This standard is not expected to impact the Company upon implementation.

In July 2001, the FASB issued SFAS no. 142, *Goodwill and Other Intangible Assets*. This statement applies to goodwill and intangible assets acquired after June 30, 2001, as well as goodwill and intangible assets previously acquired, and is effective for the Company for the first quarter in the fiscal year ended December 2002. Under this statement goodwill as well as certain other intangible assets, determined to have an infinite life, will no longer be amortized, instead these assets will be reviewed for impairment on a periodic basis. As of September 30, 2001, the Company had approximately $43,100,000 of goodwill and other intangible assets as well as a subscription receivable for $29,600,000 of additional goodwill and other intangible assets related to its transaction with CEC (see Note 2). Management is currently evaluating the impact that this statement will have on the Company's financial statements.

In June 2001, the FASB issued SFAS No. 143, *Accounting for Asset Retirement Obligations*. This statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. This statement applies to all entities. It applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and (or) the normal operation of a long-lived asset, except for certain obligations of lessees. This statement amends FASB Statement No. 19 and is effective for financial statements issued for fiscal years beginning after June 15, 2002. Management is currently evaluating the impact that this statement will have on the Company's financial statements.

In August 2001, the FASB issued SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. This statement supercedes FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, and the accounting and reporting provisions of Accounting Principles Board Opinion No. 30, *Reporting the Results of Operations−Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*. Under this statement, it is required that one accounting model be used for long-lived assets to be disposed of by sale, whether previously held and used or newly acquired, and it broadens the presentation of discontinued operations to include more disposal transactions. The provisions of this statement are effective for financial statements issued for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years, with early adoption permitted. Management is currently evaluating the impact that this statement will have on the Company's financial statements.

(4) Long-Term Obligations

(a) 12 3/4% Senior Notes

In August 1998, NEON Optica sold $180,000,000 of 12 3/4% Senior Notes due 2008 ("Senior Notes") to the public in the debt offering. The Senior Notes are due on August 15, 2008 and scheduled interest payments are due on February 15 and August 15 of each year, commencing February 15, 1999. Upon closing of the sale of the Senior Notes, NEON Optica purchased approximately $72,000,000 in U.S. Government obligations with an average maturity of 645 days to provide for payment in full of the

first seven scheduled interest payments on the Senior Notes. Such securities are pledged as security for the benefit of the holders of the Senior Notes, are classified as held-to-maturity and reported at amortized cost and are included as restricted investments in the accompanying consolidated balance sheets. The Senior Notes are redeemable in whole or in part at the option of NEON Optica at any time on or after August 15, 2003 at the following redemption prices expressed as a percentage of principal plus accrued interest through the date of redemption:

Period	Redemption Price
2003	106.375%
2004	104.250

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2005	102.125
Thereafter	100.000

In the event of a change in control, as defined, each holder of the Senior Notes will be entitled to require NEON Optica to purchase all or a portion of such holder's Senior Notes at a purchase price equal to 101% of the principal amount thereof, plus accrued and unpaid interest, if any, to the date of purchase. The Senior Notes are unsecured obligations and rank *pari passu* in right of payment with all existing and future indebtedness of NEON Optica that is not subordinated by its terms in right of payment and priority to the Senior Notes and is senior in right-of-payment to all future subordinated indebtedness of NEON Optica.

The Senior Notes are thinly traded and are currently trading substantially below their face amount. As of September 30, 2001, the fair value of the Senior Notes was $50,400,000, based on the market price on that date.

In connection with this financing, NEON Optica incurred approximately $6,300,000 of issuance costs. These costs have been classified as deferred financing costs in the accompanying consolidated balance sheet and are being amortized, as additional interest expense, over the term of the Senior Notes.

(b) 18% Subordinated Convertible Notes

On June 15, 2001, the Company closed financing of $15,000,000 in the form of an 18% subordinated convertible note ("NU Convertible Note") with Mode 1 Communications, Inc., a subsidiary of Northeast Utilities ("NU"). The NU Convertible Note matures on August 15, 2008, and scheduled interest payments are due semi-annually commencing August 15, 2001. The Company has the option to pay the interest in cash, common stock at a price per share of $6.00 or an additional convertible note. The NU Convertible Note and accrued interest are convertible at any time into common stock, at NU's option, at a price of $6.00 per common share, which represents 2,500,000 shares, subject to certain anti-dilution provisions.

As discussed in Note 2, on August 10, 2001, the Company closed financing of $11,500,000 in the form of an 18% subordinated convertible note with Exelon. The Exelon Convertible Note matures on August 15, 2008, and scheduled interest payments are due semi-annually commencing August 15, 2001. Exelon has the option to receive the interest in cash or common stock at a price per share of $5.00 or an additional subordinated convertible note. The Exelon Convertible Note and accrued interest are convertible at any time into common stock, at Exelon's option, at a price of $5.00 per share, which represents 2,300,000 shares of common stock, subject to certain anti-dilution provisions. The Exelon Convertible Note purchase agreement provides for an additional $10,000,000 from Exelon payable in either cash or forgiveness of the indebtedness represented by the note on or before April 15, 2002. The fair value of the Company's stock on the date the original commitment by Exelon was executed was $5.50 per share. Therefore, the Company has recorded as deferred financing fees the difference

between the conversion price and the fair value of the stock, totaling $1,150,000. This non-cash amount will be amortized as interest expense over the term of the Exelon Convertible Note.

(c) Nortel 15% Note

In August 2001, NEON Optica completed an agreement with Nortel Networks, Inc. ("Nortel"), one of its primary optical equipment providers, whereby NEON Optica refinanced its existing obligations to Nortel through the issuance of a 15% promissory note for $46,250,000. Interest and principle payments are due quarterly beginning September 30, 2001 through June 30, 2003.

(5) Preferred Stock

The Company's Restated Certificate of Incorporation authorizes the issuance of up to 2,000,000 shares of preferred stock, $0.01 par value per share. Under the terms of the Certificate of Incorporation, the Board of Directors is authorized, subject to any limitations prescribed by law, without stockholder approval, to issue such shares of preferred stock in one or more series. Each series of preferred stock shall have

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rights, preferences, privileges and restrictions, including voting rights, dividend rights, conversion rights, redemption privileges and liquidation preferences, as shall be determined by the Board of Directors. At September 30, 2001, no such shares are issued and outstanding.

(6) Sale of IRU to CEC

In January 2001, the Company entered into an agreement with CEC in which the Company granted CEC a 20-year IRU in certain fibers and a 36-month lease of certain other fibers along a route segment between White Plains, NY and New York City. The 36-month lease will convert into a 17-year IRU at the end of the lease period upon a one-time payment of $1.00. The agreement provides for an up-front payment from CEC of $4,000,000 and an additional $3,172,000 payable monthly over the 36-month lease period. A portion of the fibers provided to CEC will be included in the IRU granted from CEC to the Company under the September 2000 transaction (see Note 2). The Company provided the fiber under this agreement to CEC in May, 2001. The Company has accounted for this transaction as a fixed asset sale and sales-type lease and has recorded a gain in the second quarter of 2001 of approximately $1,515,000, which is included in other income in the consolidated statement of operations.

(7) Contingencies

On August 16, 2001, NEON Optica, Inc. filed a lawsuit against Fiber Optek Interconnect Corp. ("Fiber Optek") and its two principals, Michael S. Pascazi and Frank Zarzeka, in the Southern District of New York. The Company is seeking a judgment that the Company's termination of its construction contract with Fiber Optek was proper and is seeking damages based on breach of contract, breach of the implied covenant of good faith and fair dealing, fraudulent inducement and breach of express warranty in connection with Fiber Optek's defective and poor quality work, delay, failure to cooperate, false billing practices, business slander and abuse of process in connection with Fiber Optek's publication of defamatory press releases and its filing of mechanics liens against NEON under false pretenses. On September 24, 2001, Fiber Optek filed an answer and 58 counterclaims against NEON. The counterclaims seek judgment that various liens filed by Fiber Optek against NEON are valid and seek damages including lost profits and interest for alleged breaches of contract by NEON. On October 16, 2001, Fiber Optek amended their counterclaim alleging that they were terminated without cause. NEON filed an answer to the Amended Counterclaims on October 24, 2001. The case is currently pending. There can be no assurance that NEON will prevail in its lawsuit or successfully defend itself against the counterclaim made by Fiber Optek, and the effects of this litigation may be material to NEON's financial statements.

Certain other claims arising in the ordinary course of business are pending against the Company. In the opinion of management, these claims are not expected to have a material effect on operations.

(8) Concentration of Credit Risk and Significant Customers

SFAS No. 105, *Disclosure Of Information About Financial Instruments With Off Balance Sheet Risk and Financial Instruments With Concentration Of Credit Risk*, requires disclosure of any significant off-balance sheet and credit risk concentration. Financial instruments that potentially expose the Company to concentrations of credit risk consist primarily of cash and cash equivalents, short-term investments and accounts receivable. The Company has not experienced significant losses related to receivables from any individual or groups of customers or any specific industry or geographic region. Due to these factors, management believes there is no additional credit risk inherent in the Company's accounts receivable. For the three months ended September 30, 2000 and 2001, two customers and one customer, respectively, represented 27% and 13%, respectively, of the Company's revenues. At December 31, 2000 and September 30, 2001, one customer and two customers, respectively, represented 21% and 46%, respectively, of the Company's accounts receivable.

(9) Segment Disclosure

SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information,* requires certain financial and supplementary information to be disclosed on an annual and interim basis for each reportable operating segment of an enterprise. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief

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operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. The Company's chief operating decision maker is the Chief Executive Officer of the Company.

The Company analyzes segment reporting based on dark fiber, lit fiber, collocation and other services. Dark fiber, lit fiber, collocation and other services are reported as revenue only. The Company does not allocate for management reporting or segment reporting purposes its cost of revenues and property and equipment, which represent the primarily operating costs, communications network and equipment that support each segment. Similarly, selling, general and administrative expenses are not allocated to the segments for management or segment reporting purposes.

Management utilizes several measurements to evaluate its operations and allocate resources. However, the principal measurements are consistent with the Company's financial statements. The accounting policies of the segments are the same as those described in Note 3. All of the Company's revenues and assets are located in the United States.

Revenue information for the Company's segments is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2000	2001	2000	2001
Revenues:				
Lit fiber leases	$ 2,286,504	$ 5,092,857	$ 4,782,780	$ 13,314,393
Dark fiber leases	849,870	1,249,642	2,326,706	3,542,219
Collocation services	386,245	293,489	988,756	992,267
Other services(1)	157,883	454,774	535,467	1,014,198
Total revenues	$ 3,680,502	$ 7,090,762	$ 8,633,709	$ 18,863,077

(1)

Includes amortization of nonrecurring fees for installation and design, engineering and construction services

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Cautionary Statement

This Quarterly Report on Form 10-Q includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. All statements, other than statements of historical facts, included or incorporated in this prospectus regarding our strategy, future operations, financial position, future revenues, projected costs, prospects, plans and objectives of management are forward-looking statements. The words "anticipates," "believes," "estimates," "expects," "intends," "may," "plans," "projects," "will," "would" and similar expressions are intended to identify forward-looking statements, although not all forward-looking statements contain these identifying words. We cannot guarantee that we actually will achieve the plans, intentions or expectations disclosed in our forward-looking statements, and you should not place undue reliance on our forward-looking statements. Actual results or events could differ materially from the plans, intentions and expectations disclosed in the forward-looking statements we make. We have included important factors in the cautionary statements included in this report, particularly under the heading "Risk Factors," that we believe could cause actual results or events to differ materially from the forward-looking statements that we make. Our forward-looking statements do not reflect the potential impact of any future acquisitions, mergers, dispositions, joint ventures or investments we may make. We do not assume any obligation to update any forward-looking statements.

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References in this document to "we," "us," "our" and "the Company" refer, to, NEON Communications, Inc. ("NEON Communications"), its subsidiary, NEON Optica, Inc. ("NEON Optica", formerly NorthEast Optic Network, Inc.), and NEON Optica's subsidiaries.

Overview

We are a holding company whose principal asset is all of the outstanding shares of the capital stock of NEON Optica. NEON Optica is a wholly owned subsidiary of NEON Communications and acts as the primary operating entity, generating revenue primarily through the leasing of capacity on our network. In addition, under our agreement with Consolidated Edison Communications, Inc. ("CEC") which was consummated on September 14, 2000, NEON Communications is expected to become the holder of indefeasible rights of use ("IRUs") in certain fiber optic filaments in the Northeast region, as well as certain interconnections and telecommunications facilities in and around New York City, upon delivery of such assets by CEC pursuant to the terms of their agreement.

The Company owns and operates a technologically advanced, high-bandwidth fiber optic network providing capacity on a wholesale basis to telecommunications service providers, including local, long distance and wireless telephone companies and Internet service providers. Our network currently extends from Portland, Maine to Washington, D.C. Under our agreement with CEC, which was consummated on September 14, 2000, we are working to further expand our network in and around New York City. We also intend to further expand our network capillarity south of New York City in the future. Our customers can connect directly to our network at multiple locations in the larger cities we serve and also in smaller communities along our network's routes.

To date we have experienced net losses and negative cash flow from operating activities. From our inception to present, our principal activities included building our network, developing our business plans, hiring management and other key personnel and negotiating and executing customer contracts. We expect to continue to generate net losses and negative cash flow for the foreseeable future as we expand our operations. See "Liquidity and Capital Resources".

Our network service revenues include short-term leases of lit fiber and longer-term leases of dark fiber at fixed-cost pricing over multi-year terms. Other services revenues include collocation services at our facilities as well as nonrecurring design, engineering, and construction services. We generally

receive fixed monthly payments from our customers for the leasing of capacity on our network and the use of collocation facilities and recognize revenues ratably over the term of the applicable customer agreement. Design, engineering, and construction services revenues are non-refundable and generally recognized ratably over the term of the related network services arrangement (generally ranging from one to twenty years).

Our costs consist primarily of cost of revenues, selling, general and administrative expenses, depreciation and amortization, and interest expense. Cost of revenues relates to lease payments for fiber optic facilities, operations and maintenance costs, right of way fees and property taxes. Selling, general and administrative expenses relate to expenses in connection with sales, marketing and operations infrastructure, including personnel, advertising and promotions, office facilities and management and information technology. Depreciation and amortization expense is associated with the build-out of our network, as well as goodwill from our reorganization on July 8, 1998. Interest expense relates to interest on our $180,000,000 12^3/4% Senior Notes Due 2008 issued by NEON Optica, subordinated convertible notes payable to Northeast Utilities and Exelon, and promissory note payable to Nortel Networks, as described in Note 4 to the financial statements included in this Quarterly Report.

Results Of Operations

Revenues increased by $3,410,260, or 93%, to $7,090,762 in the quarter ended September 30, 2001, compared to $3,680,502 in the quarter ended September 30, 2000. Revenues in the third quarter of 2001 were generated by recurring lease services of $6,342,499 and other service revenues of $748,263, which consists of collocation revenues and nonrecurring revenues related to design, engineering, and construction. Revenues increased by $10,229,368, or 118%, to $18,863,077 for the nine months ended September 30, 2001, compared to $8,633,709 for the nine months ended September 30, 2000. The primary reason for the increase was the growth in booking and provisioning of customer orders

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for additional network services. The largest area of growth was lit services, revenues from which increased by $2,806,353, or 123%, to $5,092,857 in the quarter ended September 30, 2001, compared to $2,286,504 in the quarter ended September 30, 2000. Lit services represented 73% and 80%, respectively, of recurring lease revenues during the quarters ended September 30, 2000 and September 30, 2001. Dark services revenue grew by 47% to $1,249,642 in the quarter ended September 30, 2001, compared to $849,870 in the quarter ended September 30, 2000.

In December 1999, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin ("SAB") No. 101, *Revenue Recognition*, which provides guidance on applying generally accepted accounting principles to recognition of revenues. We adopted SAB No. 101 in the fourth quarter of 2000. Under the guidance of SAB No. 101, we recognize revenues from nonrecurring installation charges and design, engineering and construction services ratably over the multi-year network services terms to which the nonrecurring charges ultimately relate. Prior to the issuance of SAB No. 101, revenues for these nonrecurring services were generally recognized as services were performed because the Company had no further obligations. We adopted this new accounting guidance as of January 1, 2000 and all periods presented in the condensed consolidated financial statements have been restated to reflect the effects of SAB No. 101.

Cost of revenues totaled $4,143,789 during the quarter ended September 30, 2001, an increase of 51% as compared to the $2,745,150 in the quarter ended September 30, 2000. Cost of revenues for the nine months ended September 30, 2001 was $12,487,472, an increase of 69% as compared to the $7,387,915 in the nine months ended September 30, 2000. The increase in cost of revenues reflects our overall growth in business volume during 2001. As a percentage of revenues, cost of revenues decreased to 58% for the quarter ended September 30, 2001, compared to 75% for the comparable period in 2000. As a percentage of revenues, cost of revenues decreased to 66% for the nine months ended September 30, 2001, compared to 86% for the comparable period in 2000. These improvements in cost

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of revenues as a percentage of revenues reflect the Company's revenue growth and improving network utilization.

Selling, general and administrative ("SG&A") expenses increased 20% to $5,833,388 for the quarter ended September 30, 2001, including the effect of a one-time charge of $298,402 related to staff reductions announced in August 2001, compared to $4,850,600 in the quarter ended September 30, 2000. SG&A expenses increased 89% to $19,729,425 for the nine months ended September 30, 2001, compared to $10,413,889 in the nine months ended September 30, 2000. The increased SG&A expenses reflect the overall growth in our business volume during the period. As a percentage of revenues, SG&A expenses decreased to 82% for the quarter ended September 30, 2001 compared to 132% for the same period in 2000. As a percentage of revenues, SG&A expenses decreased to 105% for the nine months ended September 30, 2001 compared to 121% for the same period in 2000. These improvements in SG&A expenses as a percentage of revenues reflect the Company's focus on operating efficiencies and overall cost management.

Depreciation and amortization expense increased 62% to $4,984,891 for the quarter ended September 30, 2001, compared to $3,078,564 for the quarter ended September 30, 2000. Depreciation and amortization expense increased 60% to $13,435,914 for the nine months ended September 30, 2001, compared to $8,419,636 for the nine months ended September 30, 2000. These increases reflect the expansion of our communications network in our Northeast and Mid-Atlantic service areas.

Interest and other income decreased 52% to $533,984 for the quarter ended September 30, 2001, compared to $1,103,195 for the quarter ended September 30, 2000. Interest and other income decreased 22% to $3,135,146 for the nine months ended September 30, 2001, compared to $3,996,640 for the nine months ended September 30, 2000. These decreases reflect the effect of lower cash and investment balances in 2001 compared to 2000.

Interest expense increased by 33% to $7,022,037 in the quarter ended September 30, 2001 from $5,287,652 in the quarter ended September 30, 2000. Interest expense increased by 8% to $17,193,882 for the nine months ended September 30, 2001 from $15,976,127 for the nine months ended September 30, 2000. Interest expense primarily relates to our $12^{3}/4$% Senior Notes Due 2008, 18% subordinated convertible notes and 15% note payable to Nortel Networks. The increase in interest expense during the periods is a result of interest on the convertible notes and the note payable to Nortel Networks, all of which were issued during 2001.

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For the quarter ended September 30, 2001, we recorded a net loss for the three and nine months ended September 30, 2001 of $74,359,359 and $100,848,470, respectively, including the effect of a one-time, non-cash charge in the third quarter of $60,000,000 to writedown our subscription receivable from Exelon upon the closing of our financing arrangement with them, as discussed more fully in Note 2 to the financial statements included in this Quarterly Report. These results are compared to our net loss for the three and nine months ended September 30, 2000 of $11,178,269 and $29,567,218, respectively. The increase in net loss is primarily attributable to the one-time $60,000,000 non-cash charge and the other factors discussed above.

Liquidity and Capital Resources

Our operations have required substantial capital investment for the design, construction and development of our network and the purchase of telecommunications equipment. Capital expenditures during the nine months ended September 30, 2000 and 2001 totaled approximately $53,600,000 and $35,700,000, respectively. We expect to continue to have substantial capital requirements in connection with (i) the expansion and improvement of our existing network, (ii) the connection of additional buildings and customers to our network, (iii) the purchase of additional telecommunications equipment, and (iv) additional expenses required to operate and maintain existing facilities.

We have funded a substantial portion of these expenditures through our public offerings of equity and debt completed on August 5, 1998, which resulted in net proceeds to us of approximately $218,000,000 (after deducting expenses and before deducting $72,000,000 in escrowed funds to cover the first seven semi-annual interest payments on our 12 3/4% Senior Notes due 2008), as well as additional convertible debt issuances totaling $26,500,000 in 2001 and vendor financing provided by Nortel Networks.

The substantial capital investment required to build our network has resulted in negative cash flow after investing activities over the last three years. This negative cash flow after investing activities is a result of the requirement to build a substantial portion of our network before we can connect revenue-generating customers. Although we expect to focus our capital spending primarily on construction and deployment of the network to support customer demands, we expect to continue to experience negative cash flow after investing activities for the foreseeable future. Accordingly, unless we seek and are able to obtain additional capital, our ability to continue this expansion will be limited by our current capital resources until sufficient cash flow after investing activities is generated.

Net cash used in operating activities was $27,556,894 and $14,027,727 for the nine months ended September 30, 2000 and 2001, respectively. Net cash used in operations for the nine months ended September 30, 2001 decreased compared to the nine months ended September 30, 2000 as a result of business volume growing at a greater rate than operating costs due to improved network utilization and cost management, as well as a greater focus on up-front payments from customers, as reflected by the growth in our deferred revenues.

Cash provided by (used in) investing activities totaled $12,702,040 and $(36,750,404) for the nine months ended September 30, 2000 and 2001, respectively. Cash flows from investing activities for the nine months ended September 30, 2000 reflect the impact of funds generated from the sale of marketable securities purchased in prior years. Our capital expenditures year over year have been decreasing significantly as we transition from being a network builder to a network solutions provider, utilizing the network we already have in place to provide optical solutions to customers. Our capital expenditures have consisted primarily of construction and deployment of telecommunications equipment to build and expand our communications network in the Northeast and Mid-Atlantic regions to support customer demands.

Cash flow provided by financing activities totaled $50,405,389 and $40,767,978 for the nine months ended September 30, 2000 and 2001, respectively. Cash flow from financing activities in the first nine months of 2001 was generated from the issuance of $26,500,000 of subordinated convertible notes payable to Northeast Utilities and Exelon bearing interest at a rate of 18% and due 2008, cash received under our agreements with CEC and Exelon, and the release of the restricted cash placed in escrow in connection with the initial public offering of our 12 3/4% Senior Notes Due 2008. All proceeds from the release of the restricted cash were used to pay our interest payments due under our 12 3/4% Senior Notes Due 2008. Cash flows from financing activities decreased in 2001 as compared to 2000 due to the timing of payments due on our optical equipment purchases as well as fewer exercises of stock options.

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We anticipate that we will continue to experience negative cash flow as we expand our network, deploy telecommunications electronic equipment and market our services to an expanding customer base, even as we focus on more customer-financed expansion activities. Cash provided by operations will not be sufficient to fund operations and the expansion and development of our system in the Northeast and Mid-Atlantic regions. As a result, we will require additional financing through some combination of commercial bank borrowings, leasing, vendor financing, strategic alliances and sale of equity or debt securities if we are to complete our expansion as currently planned. As of September 30, 2001, we had approximately $13,600,000 in unrestricted cash, cash equivalents, and short-term investments, compared to approximately $20,650,000 as of December 31, 2000.

On April 12, 2001, we filed a registration statement with the Securities and Exchange Commission relating to the possible offering from time to time of up to $25,000,000 of our common stock, preferred stock, debt securities or warrants to purchase any of the foregoing. On October 9, 2001, we filed an amendment to this registration statement naming Ramius Securities LLC as an underwriter in connection with the sale by us from time to time of shares of our common stock that could result in maximum gross proceeds to us of $7,552,998 under an equity line of credit, provided that the number of shares of our common stock to be sold pursuant to this arrangement will not exceed 1,875,000 shares without approval by our board of directors. This registration statement has not yet been declared effective by the Securities and Exchange Commission, and no securities may be sold under it until it has been declared effective.

Based on anticipated continued improvement in our results from operations, our ability to manage capital expenditures and our available cash and other sources of funding, we expect to have funds sufficient to finance our operations into the second quarter of 2002, at which time we will require additional financing. We expect that it will be difficult to obtain additional financing on acceptable terms, especially given current economic conditions, and we cannot assure you that we will be successful in doing so.

Our capital requirements may vary based upon the timing and the success of implementation of our business plan and as a result of regulatory, technological and competitive developments or if demand for our services or cash flow from operations is less than or more than expected, our plans or projections change or prove to be inaccurate, we make acquisitions, or we accelerate deployment of our network or otherwise alter the schedule or targets for the implementation of our business plan. The expectations of required future capital expenditures are based on our current estimates.

New Accounting Standards

In July 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 141, *Business Combinations*. SFAS No. 141 requires all business combinations initiated after June 30, 2001 to be accounted for using the purchase method. This statement is effective for all business combinations initiated after June 30, 2001. This standard is not expected to impact us upon implementation.

In July 2001, the FASB issued SFAS no. 142, *Goodwill and Other Intangible Assets*. This statement applies to goodwill and intangible assets acquired after June 30, 2001, as well as goodwill and intangible assets previously acquired. Under this statement goodwill as well as certain other intangible assets, determined to have an infinite life, will no longer be amortized, instead these assets will be reviewed for impairment on a periodic basis. This statement is effective for the first quarter in the fiscal year ended December 2002. We are currently evaluating the impact that this statement will have on our financial statements.

In June 2001, the FASB issued SFAS No. 143, *Accounting for Asset Retirement Obligations*. This statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. This statement applies to all entities. It applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and (or) the normal operation of a long-lived asset, except for certain obligations of lessees. This statement amends FASB Statement No. 19 and is effective for financial statements issued for fiscal years beginning after June 15, 2002. We are currently evaluating the impact that this statement will have on our financial statements.

In August 2001, the FASB issued SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. This statement supercedes FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, and

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the accounting and reporting provisions of Accounting Principles Board Opinion No. 30, *Reporting the Results of Operations−Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently*

Occurring Events and Transactions. Under this statement, it is required that one accounting model be used for long-lived assets to be disposed of by sale, whether previously held and used or newly acquired, and it broadens the presentation of discontinued operations to include more disposal transactions. The provisions of this statement are effective for financial statements issued for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years, with early adoption permitted. We are currently evaluating the impact that this statement will have on our financial statements.

RISK FACTORS

There are a number of important factors that could affect our business and future operating results, including, without limitation, the factors set forth below, and the information contained in this Quarterly Report on Form 10-Q should be read in light of such factors. Any of the following factors could have a material adverse effect on our business and our future operating results.

Risk Relating To Our Financial Situation

We have experienced significant net losses throughout our history, and are currently experiencing cash flow problems. As a result, we may need additional financing in order to fund our operations and carry out our business plan, and if we are unable to obtain this financing, our business may be severely harmed and we may be required to seek protection from our creditors under the federal bankruptcy laws.

We have incurred cumulative net losses since our inception of approximately $187,200,000, including a one-time non-cash charge of $60,000,000 recorded in the third quarter of 2001. As of September 30, 2001, we had approximately $13,600,000 in unrestricted cash, cash equivalents, and short-term investments.

Based on anticipated continued improvement in our results from operations, our ability to manage capital expenditures and our available cash and other sources of funding, we expect to have funds sufficient to finance our operations into the second quarter of 2002, at which time we will require additional financing. We expect that it will be difficult to obtain additional financing on acceptable terms, especially given current economic conditions, and we cannot assure you that we will be successful in doing so. If we are unable to obtain additional financing, we may be forced to suspend capital expenditures, downsize our operations and delay our network expansion and customer growth plans. As a result, our rate of revenue growth could cease or slow materially and the fulfillment of our business plan and the date when we might achieve profitability may be substantially delayed.

Risks Relating To Our Business Strategy

Our business strategy depends upon anticipated customer demand for our services, and our failure to obtain customers for our services at profitable rates would adversely affect our business results.

Our ability to become profitable depends upon our ability to secure a market for our services and obtain service contracts with our communications customers. Many of our targeted customers may also be our potential competitors. If our services are not satisfactory or cost competitive, our targeted customers may utilize other providers where available, or construct their own networks, which would reduce their need for our services and create future sources of competition for us.

Intense competition in the telecommunications industry from a broad range of competitors may prevent us from obtaining customers and require us to lower prices.

The telecommunications industry is highly competitive. We face substantial competition from companies with significantly greater financial and other resources whose capacity is interchangeable with the capacity we offer, including incumbent local telephone companies, competitive local telephone companies and major long distance companies. In addition, potential competitors capable of offering

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services similar to those offered by us include other communications service providers that own and operate their own networks and equipment, including cable television companies, electric utilities, microwave carriers, satellite carriers, wireless communication system operators and end-users with private communications networks. Three of our principal stockholders, Northeast Utilities, or NU, New England Business Trust (an affiliate of Energy East Corporation) and Consolidated Edison Communications, Inc., each own or have rights, through one or more affiliates, to fibers in the cable that includes a portion of our network, which permits each of them to compete directly with us in the future if they use these fibers for purposes other than their corporate requirements. Our rights-of-way are non-exclusive so that other service providers (including the utilities themselves) could install competing networks using the same rights-of-way.

Because we offer a relatively narrow range of services in comparison to some of our competitors, we cannot achieve revenues comparable to companies offering a broader array of services and may be at a competitive disadvantage with respect to the services we offer.

Unlike more diversified telecommunications companies, we derive and expect to continue to derive substantially all of our revenues from the leasing of fiber optic capacity on a wholesale basis to our customers, most of whom are telecommunications companies and Internet service providers serving end-users. The limited nature of our current services could limit our potential revenues and result in our having lower revenues than competitors which provide a wider array of services. While we are currently attempting to expand the breadth of our product offering, we cannot assure you that any new product offerings will achieve market acceptance.

Due to rapidly evolving technologies in our industry and the uncertainty of future government regulation, our current business plan may become obsolete and we may be unable to maintain a competitive position if we are unable to successfully adjust our products, services and business strategies as required.

In the future, we may become subject to more intense competition due to the development of new technologies, an increased supply of domestic and international transmission capacity, the consolidation in the industry among local and long distance service providers and the effects of deregulation resulting from the Telecommunications Act of 1996. The introduction of new services and products or the emergence of new technologies may change the cost or increase the supply of services and products similar to those that we provide. We cannot predict which of many possible future product and service offerings will be crucial to maintain our competitive position or what expenditures will be required to develop profitably and provide such products and services. Prices for our services to carriers specifically, and interstate services in general, may decline over the next several years due primarily to price competition to the extent that network providers continue to install networks that compete with our network. We also believe that there will be technological advances that will permit substantial increases in the transmission capacity of both new and existing fiber.

A limited number of customers has accounted for a significant percentage of our revenues.

Historically, a limited number of customers has accounted for a significant percentage of our revenues. In 1999, three customers accounted for 18%, 16% and 13% of revenues, respectively. In 2000, two customers accounted for 16% and 10% of revenues, respectively. For the three months ended September 30, 2000 and 2001, two customers and one customer, respectively, represented 27% and 13%, respectively, of the our revenues. At December 31, 2000 and September 30, 2001, one customer and two customers, respectively, represented 21% and 46%, respectively, of the our accounts receivable. We anticipate that our results of operations in any given period will continue to depend to a significant extent upon revenues from a relatively small number of customers.

Risks Relating To The Expansion And Operation Of Our Fiber Optic Network

The successful, timely and cost-effective expansion of our fiber optic network within the Northeast and Mid-Atlantic regions is crucial to our business plan, and depends upon numerous factors beyond our control.

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Our ability to achieve our strategic objectives depends in large part upon the successful, timely and cost-effective expansion of our fiber optic network within the Northeast and Mid-Atlantic regions. Among the major factors that could affect our success are:

- any delay or difficulty experienced by Consolidated Edison Communications in the performance of its obligations under our agreement with it; and

- the failure of both affiliated and third-party suppliers or contractors to meet their obligations to construct and maintain significant portions of our fiber optic network in a timely and cost-effective manner.

Either of these factors, or other factors, over which we have little control, could significantly hinder our ability to complete our network and execute our business plan. To date, Consolidated Edison Communications has failed to deliver certain network assets in a timely fashion under our original agreements with them. Furthermore, the September 11, 2001 terrorist attacks on the World Trade Center buildings in New York City resulted in massive damage to the utility infrastructure in southern Manhattan. As a result, we expect that Consolidated Edison will be required to divert resources from the construction of Consolidated Edison Communication's network in New York City to the repair and reconstruction of the utility infrastructure in the vicinity of the disaster site. The construction of Consolidated Edison Communication's network has already been substantially delayed, and any further delay could harm our business.

The expenditures necessary to sufficiently expand our fiber optic network and develop our services in order to satisfy the current and forecasted demands of our customers may surpass our available cash, and we may be unable to obtain additional capital to develop our services on a timely basis and on acceptable terms.

Although we have expended significant resources in building our network and the development of our customer base, we will require significant additional cash in order to expand our geographic coverage and the range of services which we can offer throughout our service area in order to be competitive in our market. These expenditures for expansion and for more services, together with associated operating expenses, may reduce our cash flow and profitability until we establish an adequate customer base throughout all of our coverage areas. To date, we have expended substantial amounts on construction of our network from the proceeds of our financing activities and, accordingly, we have generated negative cash flow. We may need to obtain additional capital to carry out our planned expansion of our services and to increase our service territory, and we cannot assure you that additional financing will be available to us or, if available, that we can obtain it on a timely basis and on acceptable terms.

We obtain some of the key components used in our fiber optic network from a single source or a limited group of suppliers, and the partial or complete loss of one of these suppliers could disrupt our operations and result in a substantial loss of revenues.

We depend upon a small group of suppliers for some of the key components and parts used in our network. In particular, we purchase cable from Lucent-Fitel and from Corning, and we purchase fiber optic equipment from Nortel Networks, Cisco Systems and Sycamore Networks. Any delay or extended interruption in the supply of any of the key components, changes in the pricing arrangements with our suppliers and manufacturers or delay in transitioning a replacement supplier's product into our network could disrupt our operations.

Our fiber optic network, which is our sole source of revenue, is vulnerable to physical damage, catastrophic outages, power loss and other disruptions beyond our control, and the occurrence of any of these failures could result in immediate loss of revenues, payment of outage credits to our customers and, more importantly, the loss of our customers' confidence and our business reputation.

Our success in marketing our services to our customers requires that we provide high reliability, high bandwidth and a secure network. Our network and the infrastructure upon which it depends are subject to physical damage, power loss, capacity limitations, software defects, breaches of security and other disruptions beyond our control that may cause interruptions in service or reduced capacity for customers. Our agreements with our customers typically provide for the payment of outage related credits (a predetermined reduction or offset against our

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lease rate when a customer's leased facility is non-operational or otherwise does not meet certain operating parameters) or damages in the event of a disruption in service. These credits or damages could be substantial and could significantly decrease our net revenues. Significant or lengthy outages would also undermine our customers' confidence in our fiber optic network and injure our business reputation.

Risks Relating To Our Rights-Of-Way

We could lose the contract rights upon which we rely to operate and maintain our network in the event of bankruptcy proceedings relating to one or more of the third parties that have granted to us the right to build and operate our network using their rights-of-way.

The construction and operation of significant portions of our fiber optic network depend upon contract rights known as indefeasible rights-of-use. Indefeasible rights-of-use are commonly used in the telecommunications industry, but remain a relatively new concept in property law. Although indefeasible rights-of-use give the holder a number of rights to control the relevant rights-of-way or fiber optic filaments, legal title remains with the grantor of the rights. Therefore, the legal status of indefeasible rights-of-use remains uncertain, and our indefeasible rights-of-use might be voidable in the event of bankruptcy of the grantor. If we were to lose an indefeasible right-of-use in a key portion of our network, our ability to service our customers could become seriously impaired and we could be required to incur significant expense to resume the operation of our fiber optic network in the affected areas.

Despite our existing rights-of-way, we may be forced to make substantial additional payments to the affected landowners or remove our network from their property, which would significantly harm our business and our results of operations.

Our indefeasible rights-of-use depend on the grantor's interest in the property on which our network is located. To the extent that a grantor of an indefeasible right-of-use has a limited easement in the underlying property and not full legal title, the adequacy of our indefeasible rights-of-use could be challenged in court. For example, in May 1999, AT&T entered into a costly settlement of a class action suit brought by landowners who asserted that the railroad-based rights-of-way upon which AT&T had relied to build portions of its fiber optic network were insufficient to permit AT&T to use these rights-of-way for telecommunications purposes.

We believe that it is likely that a number of landowners may make similar claims against us based on our use of utility rights-of-way for our telecommunications purposes. In fact, some landowners have already asserted claims against us on this basis, and, to date, in two cases, rather than electing to contest the landowners' interpretation of the scope of the easement, we have made a payment to such landowners to acquire rights-of-way meeting our requirements. We believe that the easements granted by a substantial number of landowners to grantors of our indefeasible rights-of-use are similar in scope to those with respect to which claims have been asserted, and we cannot guarantee that additional claims will not be made in the future.

Because significant portions of our fiber optic network are constructed upon rights-of-way controlled by electric utility companies which generally place the operation of their electrical facilities ahead of the operation of our fiber optic network, we may be unable to construct and operate our fiber optic network in the affected areas without periodic interruptions and delays caused by the day-to-day operations of these utility companies.

Our rights-of-way agreements with NU, Central Maine Power Company (a subsidiary of Energy East Corporation) and Consolidated Edison Communications, Inc. contain provisions which acknowledge the right of these companies to make the provision of electrical services to their own customers their top priority. These companies are required only to exercise "reasonable care" with respect to our facilities and are otherwise free to take whatever actions they deem appropriate with respect to ensuring or restoring service to their electricity customers, any of which actions could impair operation of our network. In addition, some of our ongoing operational efforts are constrained by the limited ability of the utilities to de-energize segments of their transmission and distribution facilities in order to permit construction crews to work safely. We have experienced construction delays in the past as a result of such inability to timely de-energize certain segments and we may experience such delays in the future.

Risks Relating To Government Regulation

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Federal regulation of the telecommunications industry is changing rapidly and we could become subject to unfavorable new rules and requirements which could impose substantial financial and administrative burdens on us and interfere with our ability to successfully execute our business strategies.

Regulation of the telecommunications industry is changing rapidly. Existing and future federal, state, and local governmental regulations will greatly influence our viability. Consequently, undesirable regulatory changes could adversely affect our business, financial condition and results of operations.

Revenues from telecommunications provided to end-users, which represent a portion of our revenues, are subject to contributions to the FCC's universal service fund.

While we generally do not deal directly with end-users of telecommunications and are therefore generally exempt from contributing to the FCC's Universal Service Fund, the FCC treats certain Internet service providers purchasing telecommunications as end-users. Our revenues from providing telecommunications to end-users, which represent a portion of our revenues, are therefore subject to an assessment of 6.8% for the second and third quarter of 2001. Such assessments vary and may increase from quarter to quarter. If the annual contribution amount would be less than $10,000, we would qualify for a *de minimus* exemption from contribution to the Fund.

If we become subject to regulation as a common carrier in the future, we would be subject to additional regulatory requirements.

We do not believe that we are currently a "common carrier," but that status could change based on differing interpretations of current regulations, regulatory changes and changes in the way we conduct our business. If we become regulated as a common carrier by the FCC, we would have to publicize the rates for our services and submit other reports, and would be required to contribute to federal funds including, but not limited to, those established for Telecommunications Relay Services, for the management of the North American Numbering Plan and for Local Number Portability. These regulatory requirements could impose substantial burdens on us.

The Communications Act of 1996 requires incumbent local telephone companies to provide elements of their networks to competitors on an unbundled basis. In a recent decision, the FCC determined that dark fiber is a network element that incumbent local telephone companies must provide to others. The availability of this alternative source of supply may increase competition among providers of dark fiber services and could decrease the demand for our dark fiber.

Regulatory changes could affect relationships between us, our competitors and customers in unforeseeable ways that could reduce our business opportunities.

Our relationships with the telecommunications companies with whom we deal are all affected by our respective positions in the FCC's regulatory scheme. Accordingly, changes in federal telecommunications law may affect our business by virtue of the interrelationships that exist among us and many of these regulated telecommunications entities. It is difficult for us to forecast at this time how these changes will affect us in light of the complex interrelationships that exist in the industry and the different levels of regulation.

State regulation of companies providing telecommunications services varies substantially from state to state and we may become subject to burdensome and restrictive state regulations as we expand our fiber optic network into a broader geographic area, which could interfere with our operations and our ability to meet our strategic objectives.

We may be subject to state regulation, which can vary substantially from state to state. NEON Optica's subsidiaries in New York and Connecticut have obtained authority to provide intrastate telecommunications services on a competitive common carrier basis. Therefore, these subsidiaries are subject to the obligations that applicable law places on all similarly certificated common carriers including the filing of tariffs, state regulation of certain service offerings, pricing, payment of regulatory fees and reporting requirements. The costs of compliance with these regulatory obligations, or any of the regulatory requirements of other states to which we might become subject, could have a material adverse effect on our operations. Moreover, some of our rights-of-way depend on our status as a common carrier in these states, and if that status were to be successfully challenged, those rights-of-way could be terminated.

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Municipal regulation of our access to public rights-of-way is subject to change and could impose administrative burdens that would adversely affect our business.

Local governments typically retain the ability to license public rights-of-way, subject to the federal requirement that local governments may not prohibit the provision of telecommunications services. Changes in local government regulation could impose additional costs on our business and limit our operations. Local authorities affect the timing and costs associated with our use of public rights-of-way.

Risks Relating To Our Capitalization

Because we have a large amount of debt, we will be required to devote a significant portion of our cash flow to pay interest and we may not have sufficient remaining cash flow to meet our other obligations and execute our business strategies.

We are highly leveraged. Our high degree of debt includes:

- our $15,000,000 and $11,500,000 18% subordinated convertible notes due August 15, 2008 held by Mode 1 Communications, Inc., a subsidiary of Northeast Utilities referred to as Mode 1, and Exelon, respectively;

- NEON Optica's $180,000,000 12^{3}/4% Senior Notes Due 2008 and

- NEON Optica's $46,250,000 15% note due 2003 issued to Nortel Networks, Inc.

Our high degree of debt could have adverse consequences to the holders of NEON Communications' equity securities or NEON Optica's debt securities. A substantial portion of our cash flow will be dedicated to the payment of interest associated with our debt, and such cash flow may be insufficient to meet our payment obligations on our debt in addition to paying other obligations as they become due. In addition, due to our leverage ratio, our ability to obtain any necessary financing in the future for completion of our network or other purposes may be impaired. Also, certain of our future

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borrowings may be at variable rates of interest that could cause us to be vulnerable to increases in interest rates. Because we are highly leveraged, we may be at a competitive disadvantage to our competitors and may be especially vulnerable to a downturn in our business or the economy generally, or to delays in or increases in the costs of operating and constructing our network.

In connection with NEON Optica's substantial public debt and our high degree of debt, we and NEON Optica have agreed to significant restrictions on our operations that limit our ability to enter into major corporate transactions, and as a result we may be unable to pursue potential corporate opportunities which would benefit us and our stockholders.

The indenture under which NEON Optica's debt was issued imposes significant operating and financing restrictions on us and our present and future subsidiaries. These restrictions affect, and in certain cases significantly limit or prohibit, among other things, our ability to incur indebtedness, pay dividends and make other restricted payments, create liens, issue and sell capital stock of subsidiaries, guarantee indebtedness, sell assets or consolidate, merge or transfer all or substantially all of our assets. Furthermore, our agreements with Exelon and Mode 1 limit our ability to incur additional indebtedness. These limitations could prevent us from exploiting corporate opportunities as they arise, which could be detrimental to the interests of our stockholders.

Our public debt is thinly traded and is currently trading substantially below its face amount. As a result, we may, from time to time, pursue alternatives to purchase or exchange this debt in order to reduce future cash interest and principal payments.

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We are aware that our $12^3/4\%$ Senior Notes due 2008 issued by NEON Optica are thinly traded and are currently trading substantially below their face amount. In order to reduce future cash interest payments, as well as future amounts due at maturity, the Company may, from time to time, purchase such securities for cash, exchange them for common stock under the exemption provided by Section 3(a)(9) of the Securities Act of 1933, or acquire such securities for a combination of cash and common stock, in each case in open market or privately negotiated transactions, subject to any applicable restrictions set forth in the indenture relating to the Senior Notes. We will evaluate any such transactions in light of then existing market conditions, taking into account our present liquidity and prospects for future access to capital. The amounts involved in any such transactions, individually or in the aggregate, may be material.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

We are exposed to market risk related to changes in interest rates, but do not believe that this exposure is material. We do not use derivative financial instruments for speculative or trading purposes.

We maintain a short-term investment portfolio consisting mainly of corporate debt securities and U.S. government agency discount notes with an average maturity of less than three months. These held-to-maturity securities are subject to interest rate risk and will fall in value if market interest rates increase. If market interest rates were to increase immediately and uniformly by 10% from levels that existed at September 30, 2001, the fair value of the portfolio would decline by an immaterial amount. Because we have the ability to hold our fixed income investments until maturity, we would not expect our operating results or cash flows to be materially affected.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

On August 16, 2001, NEON Optica, Inc. filed a lawsuit against Fiber Optek Interconnect Corp. ("Fiber Optek") and its two principals, Michael S. Pascazi and Frank Zarzeka, in the Southern District of New York. We are seeking a judgment that our termination of our construction contract with Fiber Optek was proper and are seeking damages based on breach of contract, breach of the implied

covenant of good faith and fair dealing, fraudulent inducement and breach of express warranty in connection with Fiber Optek's defective and poor quality work, delay, failure to cooperate, false billing practices, business slander and abuse of process in connection with Fiber Optek's publication of defamatory press releases and its filing of mechanics liens against us under false pretenses. On September 24, 2001, Fiber Optek filed an answer and 58 counterclaims against NEON Optica. The counterclaims seek judgment that various liens filed by Fiber Optek against us are valid and seek damages including lost profits and interest for alleged breaches of contract by us. On October 16, 2001, Fiber Optek amended their counterclaim alleging that they were terminated without cause. We filed an answer to the Amended Counterclaims on October 24, 2001. The case is currently pending. We cannot assure you that we will prevail in our lawsuit or successfully defend ourselves against the counterclaim made by Fiber Optek, and the effects of this litigation may be material to our financial statements.

Certain other claims arising in the ordinary course of business are pending against us. In the opinion of management, these claims are not expected to have a material effect on operations.

Item 2. Changes in Securities and Use of Proceeds

On August 10, 2001, we and Exelon Enterprises Management, Inc., or Exelon, one of our principal stockholders, entered into a purchase agreement pursuant to which Exelon purchased from us an 18% subordinated convertible note due 2008 in the principal amount of $11,500,000 (the "Note"). Exelon may convert the Note at any time into common stock of the Registrant at a conversion price of $5.00 per share, or 2,300,000 shares, subject to certain anti-dilution provisions. The interest payments under the Note may be paid in cash or shares of common stock, at the option of Exelon. The terms of the Note and the purchase and sale thereof are more fully set forth in the Subordinated

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Convertible Note Purchase Agreement and the form of 18% Subordinated Convertible Note Due 2008. Pursuant to a Registration Rights Agreement, we have granted Exelon certain registration rights with respect to the shares of our common stock issuable upon conversion of the Note.

Exelon is an accredited investor as defined in Rule 501 of the Securities Act of 1933. The Note was issued in reliance on the exemption from registration set forth under Rule 506 of the Securities Act of 1933. No underwriters were involved in the foregoing sale of securities.

Item 4. Submission of Matters to a Vote of Security Holders

Reference is made to the information set forth under Item 4 of Part II of our Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2001, which is incorporated herein by reference.

Item 6. Exhibits and Reports on Form 8-K.

(a)

Exhibits

Exhibit No.	Description
3.1	Amended and Restated Certificate of Incorporation of the Registrant, incorporated by reference to Exhibit 4.1 to the Registrant's Registration Statement on Form S-3 (Registration No. 333-70064)
3.2	Bylaws of the Registrant, incorporated by reference to Exhibit 3.02 to the Registrant's Registration Statement on Form S-4 (Registration No. 333-38600)
10.1	Subordinated Convertible Note Purchase Agreement by and between the Registrant and Exelon Enterprises Management, Inc., dated as of August 10, 2001
10.2	Registration Rights Agreement dated August 10, 2001 between the Registrant and Exelon Enterprises Management, Inc., incorporated by reference to Exhibit 4.4 to the Registrant's Registration Statement on Form S-3 (Registration No. 333-70064)
10.3	Amended and Restated Registration Rights Agreement dated August 10, 2001 among the Registrant, Consolidated Edison Communications, Inc. and Exelon Enterprises Management, Inc., incorporated by reference to Exhibit 4.5 to the Registrant's Registration Statement on Form S-3 (Registration No. 333-70064)
10.4	18% Subordinated Convertible Note Due 2008 dated August 10, 2001 issued to Exelon Enterprises Management, Inc., incorporated by reference to Exhibit 4.7 to the Registrant's Registration Statement on Form S-3 (Registration No. 333-70064)
10.5	Note dated August 14, 2001 issued to Nortel Networks, Inc. by NEON Optica

(b)

On July 24, 2001 the Company filed a Current Report on Form 8-K related to the sale of the 18% subordinated convertible note to Mode 1, a subsidiary of Northeast Utilities, in the principal amount of $15,000,000.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized, on this 14th day of November, 2001.

NEON COMMUNICATIONS, INC.

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By:	/s/ STEPHEN E. COURTER Stephen E. Courter *Chairman and Chief Executive Officer* NEON Communications, Inc.
By:	/s/ WILLIAM A. MARSHALL William A. Marshall *Chief Financial Officer and Treasurer* *(Principal Financial Officer)* NEON Communications, Inc.

Exhibit Index

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Exhibit 10.1

NEON COMMUNICATIONS, INC.

SUBORDINATED CONVERTIBLE NOTE PURCHASE AGREEMENT

This SUBORDINATED CONVERTIBLE nOTE Purchase Agreement (the "AGREEMENT") is entered into as of August 10, 2001, between NEON COMMUNICATIONS, INC., a Delaware corporation (the "COMPANY"), and EXELON ENTERPRISES MANAGEMENT, INC., a Pennsylvania corporation (the "PURCHASER").

RECITALS

WHEREAS, the Company has authorized the sale and issuance of up to a maximum of $11,500,000 in aggregate principal amount of an 18 % Subordinated Convertible Note due 2008 (the "NOTE"), which Note is convertible into shares (the "CONVERSION SHARES") of the Company's common stock, par value $.01 per share (the "COMMON STOCK") in accordance with the terms of the Note;

WHEREAS, Purchaser desires to purchase the Note on the terms and conditions set forth herein and subject to the terms and conditions of the Note; and

WHEREAS, the Company desires to issue and sell the Note to Purchaser on the terms and conditions set forth herein and as set forth in the Note.

NOW, THEREFORE, in consideration of the foregoing recitals and the mutual covenants and agreements set forth herein and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties hereto agree as follows:

1. DEFINITIONS. As used in this Agreement, the following terms have the following meanings:

1.1 "AFFILIATE" of any specified Person means any other Person, directly or indirectly, controlling or controlled by or under direct or indirect common control with such specified Person. For the purposes of this definition "control" when used with respect to any Person means the power to direct the management and policies of such Person, directly or indirectly, whether through the ownership of voting securities, by contract or otherwise and the terms "controlling" and "controlled" have meanings correlative to the foregoing.

1.2 "AGREEMENT" shall have the meaning set forth in the Preamble.

1.3 "AMENDED AND RESTATED REGISTRATION RIGHTS AGREEMENT" means that

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certain Amended and Restated Registration Rights Agreement dated as of August 10, 2001 by and among the Company, Purchaser and CEC, amending and restating the Registration Rights Agreement dated as of September 14, 2000 by and among the Company, Purchaser and CEC, substantially in the form attached hereto as EXHIBIT B.

1.4 "AMENDMENT NO. 1 TO STOCKHOLDERS AGREEMENT" means that certain Amendment No. 1 to Stockholders Agreement dated as of August 10, 2001 by and among Mode 1, CEC, Purchaser and the Company, amending the Stockholders Agreement dated as of September 14, 2000 by and among Mode 1, CEC, Purchaser and Company, substantially in the form attached hereto as EXHIBIT C.

1.5 "AMENDMENT NO. 3 TO SUBSCRIPTION AGREEMENT" means that certain Amendment No. 3 to Subscription Agreement dated as of August 10, 2001 by and among Purchaser, the Company and

Northeast Optic Network, Inc. ("Northeast Optic"), amending the Subscription Agreement dated as of November 23, 1999 by and among Purchaser, the Company and Northeast Optic, as amended on May 1, 2000 and September 6, 2000, respectively, substantially in the form attached hereto as EXHIBIT D.

1.6 "BY-LAWS" means the by-laws of the Company as in effect on the Closing Date.

1.7 "CEC" means Consolidated Edison Communications, Inc., a New York corporation.

1.8 "CERTIFICATE OF INCORPORATION" means the amended and restated certificate of incorporation of the Company as in effect on the Closing Date.

1.9 "CLOSING" shall have the meaning set forth in Section 2.3.

1.10 "CLOSING DATE" shall have the meaning set forth in Section 2.3.

1.11 "COMMON STOCK" shall have the meaning set forth in the Recitals.

1.12 "EXCHANGE ACT" means the Securities Exchange Act of 1934, as amended, and the rules and regulations of the SEC thereunder.

1.13 "GAAP" means generally accepted accounting principles as in effect from time to time in the United States of America, applied on a consistent basis both as to classification of items and amounts.

1.14 "GOVERNMENTAL AUTHORITY" means any court, administrative or regulatory agency or commission or other governmental entity or instrumentality, domestic, foreign or supranational or any department thereof.

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1.15 "INDEBTEDNESS" with respect to any Person means, without duplication: (i) all indebtedness (including principal, interest, fees and charges) of such Person for borrowed money or for the deferred purchase price of property or services other than trade payables included in current liabilities in accordance with GAAP and incurred in respect of Property or services purchased in the ordinary course of business and which obligation is payable on terms no longer than 180 days past the invoice date, (ii) the maximum amount available to be drawn under all letters of credit issued for the account of such Person and all unpaid drawings in respect of such letters of credit, and (iii) all Indebtedness of the types described in clause (i) or (ii) of this definition secured by any lien on any property owned by such Person, whether or not such Indebtedness has been assumed by such Person.

1.16 "INDENTURE" means the Indenture dated as of August 5, 1998, between the Company and U.S. Bank Trust National Association.

1.17 "MATERIAL ADVERSE EFFECT" means any materially adverse effect upon the business operation, assets, liabilities, financial condition, results of operations or business prospects of the Company or any of its Subsidiaries, or upon the ability of the Company to operate its current business or to perform the Transaction Documents, resulting from any act, omission, situation, status, event or undertaking, either singly or taken together.

1.18 "MODE 1" means Mode 1 Communications, Inc., a Connecticut corporation.

1.19 "NASDAQ" means the National Association of Securities Dealers, Inc. Automated Quotation System.

1.20 "NEON OPINION OF COUNSEL" shall mean the opinion of Paul, Hastings, Janofsky & Walker LLP, counsel to NEON, dated as of the Closing Date, substantially in the form set forth in EXHIBIT G.

1.21 "NEON SEC DOCUMENTS" means the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2000 as amended by the form 10-K/A filed on April 30, 2001; the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 31, 2001; and the Company's Proxy Statement filed on July 5, 2001.

1.22 "NOTE" shall have the meaning set forth in the Recitals.

1.23 "PERSON" means any individual, partnership, limited liability company, joint venture, corporation, trust, unincorporated organization, any other entity or Governmental Authority.

1.24 "PROPRIETARY INFORMATION" shall mean any and all confidential information or technical or business information furnished, in whatever form or

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medium, or disclosed by the Company to Purchaser including, but not limited to, Capital Expenditure proposals, annual Budget and Capital Expenditure plans, marketing plans and other financial or business data.

1.25 "PURCHASE PRICE" shall have the meaning set forth in Section 2.2.

1.26 "PURCHASER" shall have the meaning set forth in the Preamble and shall include any assignee of Purchaser which is an Affiliate of Purchaser or any assignee permitted under Section 7.5 hereof.

1.27 "REGISTRATION RIGHTS AGREEMENT" means the Registration Rights Agreement between Purchaser and the Company dated August 10, 2001 substantially in the form attached hereto as EXHIBIT E.

1.28 "SEC" means the Securities and Exchange Commission.

1.29 "SECURITIES ACT" means the Securities Act of 1933, as amended, and the rules and regulations of the SEC thereunder.

1.30 "SUBSIDIARY" shall mean (i) any corporation of which fifty percent (50%) or more of the voting stock, or any partnership of which fifty percent (50%) or more of the outstanding partnership interests, is at any time owned by the Company, or by one or more Subsidiaries of the Company, or by the Company and one or more Subsidiaries of the Company, and (ii) any other entity which is controlled or capable of being controlled by the Company or by one or more Subsidiaries of the Company or by the Company and one or more Subsidiaries of the Company.

1.31 "TERMINATION AGREEMENT" means that certain Termination Agreement between the Company, NEON Optica, Inc., PECO Energy Company and Purchaser dated as of August 10, 2001, which terminates the System Agreement between the Company, NEON Optica, Inc., PECO Energy Company and Purchaser dated as of September 14, 2000, substantially in the form attached hereto as EXHIBIT F.

1.32 "TRANSACTION DOCUMENTS" means this Agreement, the Note, Amended and Restated Registration Rights Agreement, Amendment No. 1 to Stockholders Agreement, Amendment No. 3 to Subscription Agreement, Termination Agreement and the Registration Rights Agreement.

2. AGREEMENT TO SELL AND PURCHASE; CLOSING.

2.1 AUTHORIZATION OF NOTE. On or prior to the Closing Date, the Company shall have authorized the (i) sale and issuance to Purchaser of the Note, and (ii) issuance of the Conversion Shares. The Note shall be substantially in the form attached hereto as EXHIBIT A. As used in this

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Agreement, "Note" shall include the Note issued pursuant to this Agreement, together with any Note issued in exchange therefor or replacement thereof and any Note which may be issued in payment of interest in accordance with the terms thereof.

2.2 PURCHASE AND SALE OF NOTE. Subject to the terms and conditions hereof, in reliance upon the representations of Purchaser set forth in Section 4, at the Closing, the Company hereby agrees to execute, sell and deliver to Purchaser and, in reliance upon the representations of the Company set forth in Section 3, Purchaser agrees to purchase from the Company, a Note in the aggregate principal amount of $11,500,000 (the "PURCHASE PRICE"), against receipt of funds by wire transfer to an account or accounts designated by the Company prior to the Closing as payment in full of the Purchase Price of the Note.

2.3 CLOSING. The closing of the purchase and sale of the Note under this Agreement (the "CLOSING") shall take place on August 10, 2001, at the offices of Paul, Hastings, Janofsky & Walker LLP, at 399 Park Avenue, New York, NY 10022 or at such other time or place as the Company and Purchaser may mutually agree upon (which time and place are designated as the "CLOSING DATE").

3. REPRESENTATIONS AND WARRANTIES OF THE COMPANY.

Except as set forth on a Schedule of Exceptions delivered by the Company to Purchaser at the Closing (as attached as Schedule 1 hereto), the Company hereby represents and warrants to Purchaser as of the date of the Closing Date as follows:

3.1 ORGANIZATION AND QUALIFICATION. The Company is a corporation duly incorporated, validly existing and in good standing under the laws of the State of Delaware and has all requisite corporate power and authority to own, lease and operate its properties and to carry on its business as is now being conducted. The Company is duly qualified or licensed and in good standing to do business in each jurisdiction where the conduct of its business or the ownership, leasing or operation of its respective properties require such qualification or licensing, except where the failure to be so qualified or licensed and in good standing, individually or in the aggregate, would not reasonably be expected to have a Material Adverse Effect.

3.2 AUTHORITY. The Company has all necessary corporate power and authority to execute and deliver the Transaction Documents and to consummate the transactions contemplated by the Transaction Documents. The execution and delivery by the Company of the Transaction Documents and the consummation by the Company of the transactions contemplated by the Transaction Documents have been duly and validly authorized by the Board of Directors of the Company or by a committee thereof to whom such authority has been delegated and no other corporate proceedings on the part of the Company are necessary to authorize the Transaction Documents or the consummation of the transactions contemplated by the Transaction Documents. The Transaction Documents have been duly and validly executed and delivered by the Company and, assuming the Transaction Documents constitute valid and binding agreements of each other party hereto and thereto,

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constitute valid and binding agreements of the

Company, enforceable against the Company in accordance with their respective terms, except (i) as limited by applicable bankruptcy, insolvency, reorganization, moratorium or other laws of general application affecting enforcement of creditors' rights and (ii) general principles of equity that restrict the availability of equitable remedies.

3.3 CONSENTS AND APPROVALS; NO VIOLATION.

(a) No material declaration, filing or registration with, or notice to, or authorization, consent or approval of any Governmental Authority or any consent from a third party, including any bank, alliance partner, lender, investor or other Person, is necessary for the consummation by the Company of the transactions contemplated by the Transaction Documents other than those filings or consents which have already been made or received.

(b) Neither the execution and delivery of the Transaction Documents by the Company nor the sale by the Company of the Note or the issuance of the Conversion Shares upon conversion of the Note pursuant to the terms of this Agreement and the Note will (i) conflict with or result in any breach of any provision of the Certificate of Incorporation or By-laws of the Company, (ii) result in a default (or give rise to any right of termination, cancellation or acceleration) or constitute an event which, with or without the giving of notice, lapse of time, or both, would constitute a default under any of the terms, conditions or provisions of any note, bond, mortgage, indenture, license, agreement, lease or other instrument or obligation to which the Company is a party or by which the Company or any of its respective properties is or may be bound or (iii) except for the filing with Nasdaq of the Listing Application for Additional Shares, violate any order, writ, injunction, decree, statute, rule or regulation applicable to the Company or any of its respective properties, except in the case of (ii) and (iii), any such conflict, event of default or violation which would not be reasonably likely to have a Material Adverse Effect.

(c) Neither the issuance of the Note, any payment of interest or principal on the Note, nor any conversion of all or a portion of the Note into Conversion Shares nor any setoff of the obligations of the Company due under the Note against any liability owed by Purchaser to the Company under the Termination Agreement will result in a default under the Indenture.

(d) Neither the issuance of the Note nor the conversion of the Note into Conversion Shares will trigger any anti-dilution provision contained in any existing securities or contracts or any other instrument of the Company.

3.4 NEON SEC DOCUMENTS.

(a) The capitalization of the Company, as well as its annual

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balance sheets, statements of income and statements of cash flows, are disclosed in all material respects in the NEON SEC Documents. The filed NEON SEC Documents, at the time filed with the SEC, conformed in all material respects to the then applicable requirements of the Exchange Act. The NEON SEC Documents do not contain any untrue statements of a material fact or omit to state a material fact required to be stated therein necessary in order to make the statements therein not misleading in light of the circumstances in which they were made.

(b) There has been no change to the business, assets or finances of the Company since December 31, 2000, which has not been disclosed in the NEON SEC Documents which would be reasonably expected to have a Material Adverse Effect.

3.5 LEGAL PROCEEDINGS. Except as set forth on Schedule 1 hereto, there are no claims, actions, proceedings or investigations pending or, to the knowledge of the Company, threatened against or relating to the Company which would, individually or in the aggregate, be reasonably expected to have a Material Adverse Effect.

3.6 CONVERSION SHARES. Upon conversion of the Note, the Conversion Shares, when issued and delivered to Purchaser in accordance with the terms of the Note, will be duly and validly issued, fully paid and nonassessable, and free and clear of any preemptive rights, liens and encumbrances.

3.7 OFFERING VALID. Assuming the accuracy of the representations and warranties of Purchaser contained in Section 4 hereof, the offer, sale and issuance of the Note and the Conversion Shares will be exempt from the registration requirements of the Securities Act and will have been registered or qualified (or are exempt from registration and qualification) under the registration, permit or qualification requirements of all applicable state securities laws. Neither the Company nor any agent on its behalf has solicited or will solicit any offers to sell or has offered to sell or will offer to sell all or any part of the Note to any person or persons so as to bring the sale of such Note by the Company within the registration provisions of the Securities Act or any state securities laws.

4. REPRESENTATIONS AND WARRANTIES OF PURCHASER.

Purchaser hereby represents and warrants to the Company as follows (such representations and warranties do not lessen or obviate the representations and warranties of the Company set forth in this Agreement):

4.1 REQUISITE POWER AND AUTHORITY. Purchaser has all necessary power and authority under all applicable provisions of law to execute and deliver the Transaction Documents and to consummate the transactions contemplated by the Transaction Documents. All actions on Purchaser's part required for the lawful execution and delivery of the Transaction Documents have been or will be

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effectively taken prior to the Closing. No consent or approval is needed from the SEC under the Public Utility Holding Company Act of 1935 in order for Purchaser to purchase and hold the Note or the Conversion Shares. Upon their execution and delivery, the Transaction Documents will be valid and binding obligations of Purchaser, enforceable against Purchaser in accordance with their terms, except (a) as limited by applicable bankruptcy, insolvency, reorganization, moratorium or other laws of general application affecting enforcement of creditors' rights and (b) general principles of equity that restrict the availability of equitable remedies.

4.2 INVESTMENT REPRESENTATIONS. Purchaser understands that neither the Note nor the Conversion Shares have been registered under the Securities Act. Purchaser also understands that the Note and the Conversion Shares are being offered and sold pursuant to an exemption from registration contained in the Securities Act based in part upon Purchaser's representations contained in the Agreement. Purchaser hereby represents and warrants as follows:

(a) PURCHASER BEARS ECONOMIC RISK. Purchaser has substantial experience in evaluating and investing in private placement transactions of securities in companies similar to the Company so that it is capable of evaluating the merits and risks of its investment in the Company and has the capacity to protect its own interests. Purchaser must bear the economic risk of this investment indefinitely unless the Note (or the Conversion Shares) is registered pursuant to the Securities Act, or an exemption from registration is available. Purchaser understands that, except for complying with its obligations under the Registration Rights Agreement, the Company has no present intention of registering the Note or the Conversion Shares. Purchaser also understands that there is no assurance that any exemption from registration under the Securities Act will be available and that, even if available, such

exemption may not allow Purchaser to transfer all or any portion of the Note or the Conversion Shares under the circumstances, in the amounts or at the times Purchaser might propose.

(b) ACQUISITION SOLELY FOR INVESTMENT. Purchaser is acquiring the Note and the Conversion Shares for Purchaser's own account for investment only, and not with a view to, or for sale in connection with, any distribution of such shares in violation of the Securities Act or any rule or regulation under the Securities Act.

(c) PURCHASER CAN PROTECT ITS INTEREST. Purchaser represents that by reason of its, or of its management's, business or financial experience, Purchaser has the capacity to protect its own interests in connection with the transactions contemplated by the Transaction Documents. Purchaser is aware of no publication of any advertisement in connection with the transactions contemplated by the Transaction Documents.

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(d) ACCREDITED INVESTOR. Purchaser represents that it is an accredited investor within the meaning of Regulation D under the Securities Act.

(e) COMPANY INFORMATION. Purchaser has received and read the financial statements of the Company in the NEON SEC Documents and has had an opportunity to discuss the Company's business, management and financial affairs with directors, officers and management of the Company and has had access to, and the opportunity to review, the Company's operations and facilities. Purchaser has also had the opportunity to ask questions of and receive answers from, the Company and its management regarding the terms and conditions of this investment.

(f) RULE 144. Purchaser acknowledges and agrees that the Note, and, if issued, the Conversion Shares must be held indefinitely unless they are subsequently registered under the Securities Act or an exemption from such registration is available. Purchaser has been advised or is aware of the provisions of Rule 144 promulgated under the Securities Act as in effect from time to time, which permits limited resale of shares purchased in a private placement subject to the satisfaction of certain conditions, including, among other things, the availability of certain current public information about the Company, the resale occurring following the required holding period under Rule 144 and the number of shares being sold during any three-month period not exceeding specified limitations.

(g) RESIDENCE. The office or offices of Purchaser in which its investment decision was made is located at the address or addresses of Purchaser set forth in Section 7.9 hereof.

5. CONDITIONS TO CLOSING.

5.1 CONDITIONS TO PURCHASER'S OBLIGATIONS AT THE CLOSING. Purchaser's obligations to purchase the Note at the Closing are subject to the satisfaction, at or prior to the Closing Date, of the following conditions:

(a) REPRESENTATIONS AND WARRANTIES TRUE; PERFORMANCE OF OBLIGATIONS. The representations and warranties made by the Company in Section 3 hereof shall be true and correct in all material respects as of the Closing Date with the same force and effect as if they had been made as of the Closing Date, and the Company shall have performed all obligations and conditions herein required to be performed or observed by it on or prior to the Closing.

(b) OFFICER'S CERTIFICATE. The Company shall have delivered to Purchaser a Certificate, executed by the President of the Company, dated the Closing Date, to the effect that the conditions specified in subsection (a) of this Section 5.1 have been satisfied.

(c) REGISTRATION RIGHTS AGREEMENT. Each of Purchaser and the

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Company shall have executed and delivered the Registration Rights Agreement.

(d) NOTE. The Note shall have been executed and delivered by the Company to Purchaser.

(e) WAIVER. The Company shall have obtained from CEC a waiver of its right of first refusal under Section 5.05 of the Subscription Agreement between the Company and CEC dated as of November 23, 1999, and as amended on May 1, 2000 and September 6, 2000.

(f) AMENDED AND RESTATED REGISTRATION RIGHTS AGREEMENT. Each of CEC, the Company and Purchaser shall have executed and delivered the Amended and Restated Registration Rights Agreement.

(g) AMENDMENT NO. 1 TO STOCKHOLDERS' AGREEMENT. Each of Mode 1, CEC, Purchaser and the Company shall have executed and delivered Amendment No. 1 to Stockholders' Agreement.

(h) AMENDMENT NO. 3 TO SUBSCRIPTION AGREEMENT. Each of Northeast Optic Network, Inc., the Company and Purchaser shall have executed and delivered Amendment No. 3 to Subscription Agreement.

(i) TERMINATION AGREEMENT. Each of Purchaser, the Company, PECO Energy Company and NEON Optica, Inc. shall have executed and delivered the Termination Agreement.

(j) NEON OPINION OF COUNSEL. Purchaser shall have received the NEON Opinion of Counsel.

(k) STOCKHOLDER APPROVAL. If required by law, Nasdaq rules or otherwise, the Company shall have obtained approval of the issuance of the Notes and the Conversion Shares by the Company's stockholders holding a majority of the outstanding shares of Common Stock entitled to vote in person or by proxy.

5.2 CONDITIONS TO OBLIGATIONS OF THE COMPANY. The Company's obligation to issue and sell the Note at Closing is subject to the satisfaction, on or prior to Closing, of the following conditions:

(a) REPRESENTATIONS AND WARRANTIES TRUE. The representations and warranties made by Purchaser in Section 4 hereof shall be true and correct in all material respects at the Closing Date.

(b) PERFORMANCE OF OBLIGATIONS. Purchaser shall have performed and complied with all agreements and conditions herein required to be performed or complied with by Purchaser on or before the Closing.

(c) PURCHASE PRICE. Purchaser shall have delivered to the Company an amount equal to the Purchase Price.

(d) REGISTRATION RIGHTS AGREEMENT. Each of Purchaser and the Company shall have executed and delivered the Registration Rights Agreement.

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(e) AMENDED AND RESTATED REGISTRATION RIGHTS AGREEMENT. Each of Purchaser, the Company and CEC shall have executed and delivered the Amended and Restated Registration Rights Agreement.

(f) TERMINATION AGREEMENT. Each of Purchaser, the Company, PECO Energy Company and NEON Optica, Inc. shall have executed and delivered the Termination Agreement.

(g) FAIRNESS OPINION. The Company shall have received an opinion from a nationally recognized investment banking firm that the transactions contemplated by the Transaction Documents are fair, from a financial standpoint, to the Company and its Subsidiaries.

(h) STOCKHOLDER APPROVAL. If required by law, Nasdaq rules or otherwise, the Company shall have obtained approval of the issuance of the Notes and the Conversion Shares by the Company's stockholders holding a majority of the outstanding shares of Common Stock entitled to vote in person or by proxy.

6. COVENANTS OF THE COMPANY.

So long as the aggregate principal amount of the Note outstanding is greater than or equal to one million dollars ($1,000,000), the Company shall observe and perform the following covenant:

6.1 INCURRENCE OF INDEBTEDNESS. The Company shall not incur, directly or indirectly, any Indebtedness which is equal or senior in ranking to the Note without the written consent of Purchaser.

7. MISCELLANEOUS.

7.1 STOCKHOLDER APPROVAL. At any meeting of the stockholders of the Company at which approval of the issuance of the Note has been submitted for stockholder action, Purchaser hereby agrees to vote all of the shares of Common Stock it is entitled to vote in person or by proxy at such meeting authorizing the issuance of the Note.

7.2 TERMINATION. This Agreement may be terminated by written notice by one party to the other if the Closing Date has not occurred (other than through the failure of the party seeking to terminate this Agreement to comply fully with its obligations under this Agreement) on or before September 1, 2001, or such later date as the parties hereto may agree in writing. If this Agreement is terminated pursuant to this Section 7.2, all further obligations of the parties under this Agreement will terminate, except that the obligations in Section 7.3 hereof will survive.

7.3 PROPRIETARY INFORMATION.

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(a) PROTECTION OF PROPRIETARY INFORMATION. The Company and Purchaser hereby agree that if the Company provides (or prior to the execution of this Agreement, has provided) any Proprietary Information to Purchaser, such Proprietary Information shall be held in confidence, and Purchaser shall afford such Proprietary Information the same care and protection as it affords generally to its own confidential and proprietary information (which in any case shall be not less than reasonable care) in order to avoid disclosure to or unauthorized use by any third party.

(b) OWNERSHIP OF PROPRIETARY INFORMATION. All Proprietary Information, unless otherwise specified in writing, shall remain the property of the Company, shall be used by

Purchaser only for the intended purpose, and such written Proprietary Information, including all copies thereof, shall be returned to the Company or destroyed after Purchaser's need for it has expired or upon the request of the Company. Proprietary Information shall not be reproduced except to the extent necessary to accomplish the purpose and intent of this Agreement, or as otherwise may be permitted in writing by the Company.

(c) EXCEPTIONS. The foregoing provisions of this Section 7.3 shall not apply to any Proprietary Information which (i) becomes publicly available other than through Purchaser; (ii) is required to be disclosed by a governmental or judicial law, order, rule or regulation; (iii) is developed independently by Purchaser; (iv) becomes available to Purchaser without restriction from a third party; or (v) becomes relevant to the settlement of any dispute or enforcement of either party's rights under this Agreement in accordance with the provisions of this Agreement, in which case appropriate protective measures shall be taken to preserve the confidentiality of such Proprietary Information as fully as possible within the confines of such settlement or enforcement process. If any Proprietary Information is required to be disclosed pursuant to the foregoing clause (ii), Purchaser shall promptly inform the Company in writing of the requirements of such disclosure.

(d) PERMITTED DISCLOSURES. Notwithstanding the foregoing, Purchaser may disclose Proprietary Information to its employees, agents, and legal, financial, and accounting advisors and providers (including its lenders and other financiers) to the extent necessary or appropriate in connection with the negotiation and/or performance of this Agreement or its obtaining of financing, PROVIDED; that each such party is notified of the confidential and proprietary nature of such Proprietary Information and is subject to or agrees to be bound by similar restrictions on its use and disclosure of Proprietary Information.

7.4 GOVERNING LAW. This Agreement shall be governed in all respects by the laws of the Commonwealth of Pennsylvania, regardless of conflicts of laws

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principles.

7.5 SUCCESSORS AND ASSIGNS. Except as otherwise expressly provided herein, the provisions hereof shall inure to the benefit of, and be binding upon, the successors, assigns, heirs, executors and administrators of the parties hereto and shall inure to the benefit of and be enforceable by each Person who shall be a holder of the Note from time to time. The Note and the rights of the holder of the Note under this Agreement are fully assignable: (a) to Affiliates of the holder without the prior approval of the Company; and (b) to third parties without the prior approval of the Company.

7.6 ENTIRE AGREEMENT. This Agreement, the Exhibits and Schedules hereto and the other documents delivered pursuant hereto constitute the full and entire understanding and agreement between the parties with regard to the subjects hereof and no party shall be liable or bound to any other in any manner by any representations, warranties, covenants and agreements except as specifically set forth herein and therein.

7.7 SEVERABILITY. In case any provision of the Agreement shall be invalid, illegal or unenforceable, the validity, legality and enforceability of the remaining provisions shall not in any way be affected or impaired thereby.

7.8 AMENDMENT AND WAIVER. This Agreement may be amended or modified only upon the written consent of the Company and the holder of the Note. The obligations of the Company and the rights of the holder of the Note under the Agreement may be waived only with the written consent of the holder of the Note.

7.9 NOTICES. All notices and other communications hereunder shall be in writing and shall be deemed given (as of the time of delivery or, in the case of a telecopied communication, of confirmation and accompanied by another manner of giving notice provided in this Section 7.9) if delivered personally, telecopied (which is confirmed) or sent by overnight courier (providing proof of delivery) to the parties at the following addresses (or at such other address for a party as shall be specified by like notice):

if to the Company, to:

NEON Communications, Inc.
2200 West Park Drive
Westborough, MA 01581
Attention: Stephen A. Bogiages, General Counsel
Facsimile Number: (508) 616-7895

with a copy to:

Paul, Hastings, Janofsky & Walker LLP
1055 Washington Boulevard

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Stamford, CT 06901
Attention: Esteban A. Ferrer, Esq.
Facsimile Number: (203) 359-3031

if to Purchaser, to:

Exelon Enterprises Management, Inc.
2301 Market Street
Philadelphia, PA 19101
Attention: President
Facsimile: (215) 841-6374

with a copy to:

Exelon Business Services Legal
2301 Market Street, 23rd Floor
Philadelphia, PA 19103
Attention: John Halderman, Esq.
Facsimile: (215) 841-4474

7.10 EXPENSES. Each party shall pay the costs and expenses that it incurs with respect to the negotiation, execution, delivery and performance of the Agreement.

7.11 TITLES AND SUBTITLES. The titles of the sections and subsections of the Agreement are for convenience of reference only and are not to be considered in construing this Agreement.

7.12 COUNTERPARTS. This Agreement may be executed in any number of counterparts, each of which shall be an original, but all of which together shall constitute one instrument.

7.13 PRONOUNS. All pronouns contained herein, and any variations thereof, shall be deemed to refer to the masculine, feminine or neutral, singular or plural, as to the identity of the parties hereto may require.

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In Witness Whereof, the parties hereto have executed this Agreement as of the date set forth in the first paragraph hereof.

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COMPANY:

NEON COMMUNICATIONS, INC.

By: /s/ STEPHEN E. COURTER

Name: STEPHEN E. COURTER

Title: CHIEF EXECUTIVE OFFICER

Address: 2200 West Park Drive
Westborough, MA 01581

PURCHASER:

EXELON ENTERPRISES MANAGEMENT, INC.

By: /s/ ROBERT A. SHINN

Name: ROBERT A. SHINN

Title: PRESIDENT

Address: 2301 Market Street
Philadelphia, PA 19103

SUBORDINATED CONVERTIBLE NOTE PURCHASE AGREEMENT
SIGNATURE PAGE

SCHEDULE 1

SCHEDULE OF EXCEPTIONS

SECTION 3.3

Listing Application for Additional Shares to be filed with the NASD, Inc.

Waiver of Right of First Refusal by CEC under Section 5.05 of the Subscription Agreement between the Company and CEC dated as of November 23, 1999, and as amended on May 1, 2000 and September 5, 2000.

SECTION 3.5

On May 7, 2001, Neon Optica, Inc. was named as defendant in a case entitled Fiber Optek Interconnect Corp. v. Neon Optica, Inc. f/k/a Northeast Optic Network, Inc. The Complaint, which was filed in New York State Supreme Court in Westchester County on May 7, 2001, sought damages of $24 million related to its construction contracts with the defendants. During settlement discussions between Fiber Optek and the Company, Fiber Optek agreed to the dismissal of the lawsuit without prejudice. On May 16, 2001, Fiber Optek filed a "Voluntary

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Discontinuance Without Prejudice" and on June 8, 2001, the Company filed a Notice of Removal of the case to the U.S. District Court for the Southern District of New York. On July 30 ,2001, the Company moved to dismiss the action based on Fiber Optek's May 16, 2001 "Voluntary Discontinuance Without Prejudice". To date, Fiber Optek has filed mechanics' liens in White Plains, Rye, New Rochelle, and Harrison, New York upon real property of the Company in such locations, including optical cable networks and license agreements. While it is not possible to predict the ultimate outcome of the Company's negotiations with Fiber Optek, the Company believes that this matter will not have a Material Adverse Effect.

On July 18, 2001, the Company's agent was served by a complaint filed by Stephen F. and Joan Pach of East Haddam, Connecticut, in the Middlesex District of the Connecticut Superior Court, alleging trespass and damage to their property in the Company's installation and use of a fiber optic cable on an easement owned by Northeast Utilities traversing the Pach property. The Company is required to answer the complaint on August 14, 2001 and expects to contest the claim. While it is not possible to predict the ultimate outcome of this claim, the Company believes that this matter will not have a Material Adverse Effect.

EXHIBIT A

SUBORDINATED CONVERTIBLE NOTE

EXHIBIT B

AMENDED AND RESTATED REGISTRATION RIGHTS AGREEMENT

EXHIBIT C

AMENDMENT NO. 1 TO STOCKHOLDERS AGREEMENT

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EXHIBIT D

AMENDMENT NO. 3 TO SUBSCRIPTION AGREEMENT

EXHIBIT E

REGISTRATION RIGHTS AGREEMENT

EXHIBIT F

TERMINATION AGREEMENT

EXHIBIT G

NEON OPINION OF COUNSEL

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Exhibit 10.5

SENIOR NOTE

$46,250,000.00 New York, New York August 14, 2001

FOR VALUE RECEIVED, the undersigne d, NEON OPTICA, INC., a Delaware corporation ("MAKER"), promises to pay to the order of NORTEL NETWORKS INC., a Delaware corporation ("PAYEE"), the principal sum of FORTY-SIX MILLION TWO HUNDRED FIFTY THOUSAND AND NO/100 DOLLARS ($46,250,000.00), together with interest as provided below. All payments on this Senior Note (the "NOTE") shall be due and payable in lawful money of the United States of America, without offset, counterclaim or deduction, at the office of Payee at 2221 Lakeside Boulevard, Richardson, Texas 75082-4399, or such other place as Payee shall request.

1. INDEBTEDNESS. The indebtedness evidenced by this Note represents amounts to be paid by Maker to Payee for goods and services provided by Payee to Maker.

2. SECURITY. The indebtedness evidenced by this Note is secured by the security interests granted under that certain Network Products Purchase Agreement dated effective as of March 23, 1998, by and between Maker and Payee, as amended by that certain Amendment No. 1 dated effective as January 4, 1999, by and between Maker and Payee (as amended, the "NPPA").

3. INTEREST. The unpaid principal balance from day to day outstanding hereunder shall bear interest at a rate per annum which shall from day to day be equal to the lesser of (a) fifteen percent (15%), based upon a 365 or 366-day year (as applicable) and the actual number of days elapsed, or (b) the Maximum Lawful Rate (as hereinafter defined). All past due principal of and, to the extent permitted by law, accrued interest on this Note shall bear interest from maturity (whether by acceleration or otherwise) until paid at an annual rate equal to the lesser of (i) eighteen percent (18%), based upon a 365 or 366-day year (as applicable) and the actual number of days elapsed, or (ii) the Maximum Lawful Rate.

4. PAYMENTS, MATURITY. Accrued but unpaid interest on this Note shall be due and payable quarterly in arrears on the last day of each calendar quarter beginning on September 30, 2001 and continuing on the last day of each calendar quarter thereafter through and including June 30, 2003 (the "MATURITY DATE"). Default interest shall be due on demand. The unpaid principal balance of this Note shall be due and payable in eight equal quarterly installments of $5,781,250, on the last day of each calendar quarter beginning on September 30, 2001, and continuing on the last day of each calendar quarter thereafter through

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and including the Maturity Date. The unpaid principal balance of this Note and all accrued but unpaid interest thereon shall be due and payable in full on the Maturity Date.

5. VOLUNTARY PREPAYMENTS. The unpaid principal balance of this Note may be prepaid in increments of at least $1,000,000 beginning one year after the date hereof. No amounts prepaid may be re-borrowed.

6. MANDATORY PREPAYMENTS. Maker shall make a mandatory prepayment on this Note with one hundred percent of the proceeds of any sale, transfer or other disposition of any of the "Products" as such term is defined in the NPPA (hereinafter referred to as the "COLLATERAL"), including the amount of any insurance recovery or condemnation payment with respect to any of the Collateral. Any such payment will be due concurrently with the receipt of such funds by the Maker. This requirement does not authorize the disposition of any Collateral. Maker shall make a mandatory prepayment on this Note in the amount of fifty percent of the net proceeds (gross proceeds less reasonable and customary expenses of issuance paid to third parties) of any offerings of debt or equity securities by Maker or NEON Communications, Inc. ("HOLDINGS"); provided, however, that no such payment shall be required from the proceeds of debt or equity offerings until the gross proceeds of all such offerings after the date hereof exceed $50,000,000.

7. FINANCIAL REPORTING. So long as any amounts remain outstanding hereunder, Maker agrees to provide to Payee quarterly, no more than 45 days after the end of each calendar quarter beginning with the calendar quarter ending June 30, 2001, a copy of (i) an unaudited financial report of Holdings and its consolidated subsidiaries as of the end of such quarter and for the portion of the fiscal year then ended containing, on a consolidated and consolidating basis, balance sheets and statements of income, retained earnings and cash flow, in each case setting forth in comparative form the figures for the corresponding period of the preceding fiscal year, all in reasonable detail certified by the chief financial officer of Holdings to have been prepared in accordance with generally accepted accounting principles consistently applied ("GAAP") and to fairly and accurately present (subject to year-end audit adjustments) the financial condition and results of operations of Holdings and its consolidated subsidiaries, on a consolidated and consolidating basis, at the date and for the periods indicated therein and (ii) management's financial reports comparing actual financial results for the period to the current budget for the period. Payee acknowledges and agrees that Maker may provide Payee a copy of the form 10-Q (including all financial statements contained therein) or form 10-K (including all financial statements contained therein) or any successor form, as applicable, filed with the Securities and Exchange Commission by Holdings for the applicable reporting period in satisfaction of Maker's reporting obligations under this PARAGRAPH 7 and that certification by the chief financial officer shall not be required, provided that such reports include the information required by this PARAGRAPH 7.

8. MAINTENANCE OF INSURANCE. Maker will keep insured by financially

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sound and reputable insurers all property and other assets of a character usually insured by responsible corporations engaged in the same or a similar business similarly situated against loss or damage of the kinds and in the amounts customarily insured against by

such corporations or entities and carry such other insurance as is usually carried by such corporations or entities, PROVIDED that in any event Maker will maintain (a) general liability insurance with coverage of at least $1,000,000 and (b) worker's compensation insurance (including employers' liability insurance) to the extent required by applicable law, which may be self-insurance to the extent permitted by applicable law. Such insurance shall be written by financially responsible companies selected by Maker and having an A.M. Best Rating of "A-" or better and being in a financial size category of "VI" or larger, or by other companies reasonably acceptable to Payee. Each policy referred to in this PARAGRAPH 7 shall provide that it will not be canceled, amended or reduced except after not less than 30 days' prior written notice to Payee, shall name Payee as additional insured and as loss payee as its interest may appear, and shall also provide that the interests of Payee shall not be invalidated by any act or negligence of Maker. Maker will advise Payee promptly of any policy cancellation, reduction or amendment. Maker shall provide to Payee original certificates evidencing all such policies of insurance and, at the request of Payee, copies of such policies.

9. DEBT. Maker will not, nor will it permit any of its subsidiaries to, incur, create, assume or permit to exist any Debt, except:

(a) Debt evidenced by this Note; and

(b) existing Debt in the principal amounts and as otherwise described on SCHEDULE 9 hereto.

As used herein, "DEBT" means as to any natural person, corporation, partnership, trust, limited liability company, or other organization or entity (any of the foregoing being referred to hereinafter as a "PERSON") at any time (without duplication): (a) all indebtedness, liabilities and obligations of such Person for borrowed money; (b) all indebtedness, liabilities and obligations of such Person evidenced by bonds, notes, debentures or other similar instruments; (c) all indebtedness, liabilities and obligations of such Person to pay the deferred purchase price of property or services, except trade accounts payable of such Person arising in the ordinary course of business that are not past due by more than 90 days; (d) all capital lease obligations of such Person, except capital lease obligations of such Person arising in the ordinary course of business that are related to the maintenance or improvement of such Person's telecommunications network and that do not exceed $7,500,000 in the aggregate at any time; (e) all Debt of others guaranteed by such Person; (f) all indebtedness, liabilities and obligations secured by a Lien existing on property owned by such Person, whether or not the indebtedness, liabilities or

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obligations secured thereby have been assumed by such Person or are non-recourse to such Person; (g) all reimbursement obligations of such Person (whether contingent or otherwise) in respect of letters of credit, bankers' acceptances, surety or other bonds and similar instruments, except obligations of such Person arising in the ordinary course of business that are related to such Person's telecommunications network and that do not exceed $5,000,000 in the aggregate at any time; (h) all indebtedness,

liabilities and obligations of such Person to redeem or retire shares of capital stock of such Person; (i) all indebtedness, liabilities and obligations of such Person under interest rate protection agreements; and (j) all indebtedness, liabilities and obligations of such Person in respect of unfunded vested benefits under any pension plans.

10. CONTRIBUTIONS TO THE EQUITY CAPITAL OF MAKER. Maker represents and warrants to Payee that the net proceeds of the convertible debt issued by Holdings to Mode 1 Communications, Inc. and Exelon Enterprises Management Inc. have been contributed as equity to the capital of Maker.

11. ABSENCE OF LIENS. Maker will not permit or suffer to exist, and will not permit Holdings to create or suffer to exist, any Lien on or with respect to any of its respective assets or properties other than Permitted Liens. As used in this Note, "LIEN" shall mean any lien, mortgage, security interest, tax lien, financing statement, pledge, charge, hypothecation or other encumbrance of any kind or nature whatsoever (including, without limitation, any conditional sale or title retention agreement), whether arising by contract, operation of law or otherwise. As used in this Note, "PERMITTED LIENS" shall have the meaning assigned to that term in the Indenture dated as of August 5, 1998 between NorthEast Optic Network, Inc. and U.S. Bank Trust National Association, as Trustee, for 12-3/4% Senior Notes Due 2008.

12. RESTRICTED PAYMENTS. Maker will not, and will not permit Holdings to, make any Restricted Payments. As used in this Note, a "RESTRICTED PAYMENT" means (a) any dividend or other distribution (whether in cash, property or obligations), direct or indirect, on account of (or the setting apart of money for a sinking or other analogous fund for) any shares, interests, rights to purchase, warrants, options, participation or other equivalents of or interests in (however designated) equity of such Person, including any preferred stock, but excluding any debt securities convertible into such equity ("CAPITAL STOCK") of Maker or Holdings now or hereafter outstanding, except a dividend payable solely in Capital Stock of Maker or Holdings, respectively; and (b) any redemption, conversion, exchange, retirement, sinking fund or similar payment, purchase or other acquisition for value, direct or indirect, of any Capital Stock of Maker or Holdings now or hereafter outstanding. This PARAGRAPH 12 shall not prohibit the repurchase or other acquisition of shares of, or options to purchase shares of, common stock of Holdings or Maker from employees, former employees, directors or former directors of Holdings or Maker (or permitted

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transferees of such employees, former employees, directors or former directors), pursuant to the terms of the agreements (including employment agreements) or plans (or amendments thereto) approved by the Board of Directors of Holdings under which such individuals purchase or sell, or are granted the option to purchase or sell, shares of such common stock; provided, however, that the aggregate amount of such repurchases and other acquisitions shall not exceed $500,000 in any calendar year.

13. AFFILIATE TRANSACTIONS. Maker will not, and will not permit Holdings to, enter into or permit to exist any transaction (including the purchase, sale, lease or exchange of any property, employee compensation arrangements or the rendering of any service) with any Affiliate of Maker or Holdings (an "AFFILIATE TRANSACTION") unless the terms thereof (i) are no less favorable to Maker or Holdings than those that could be obtained at the time of such transaction in arm's-length dealings with a Person who is not such an Affiliate, (ii) if such Affiliate Transaction involves an amount in excess of $1,000,000, (1) are set forth in writing and (2) have been approved by a majority of the members of the Board of Directors of Holdings having no personal stake in such Affiliate Transaction and (iii) if such Affiliate Transaction involves an amount in excess of $5,000,000, have been determined by a nationally recognized investment banking firm to be fair, from a financial standpoint, to Maker and Holdings. The provisions of this PARAGRAPH 13 shall not prohibit (i) any Restricted Payment permitted to be paid pursuant to PARAGRAPH 12 of this Note, (ii) any issuance of securities, or other payments, awards or grants in cash, securities or otherwise pursuant to, or the funding of, employment arrangements, stock options and stock ownership plans approved by the Board of Directors of Holdings, (iii) the grant of stock options or similar rights to employees and directors of Maker or Holdings pursuant to plans approved by the Board of Directors of Holdings, (iv) loans or advances to employees in the ordinary course of business in accordance with the past practices of Maker or Holdings, but in any event not to exceed $1,000,000 in the aggregate outstanding at any one time, (v) the payment of reasonable fees to directors of Maker or Holdings who are not employees of Maker or Holdings, (vi) any Affiliate Transaction between Maker and Holdings or between subsidiaries of Holdings not designated as unrestricted subsidiaries by the Board of Directors of Holdings and (vii) the issuance or sale of Capital Stock of Holdings. As used in this Note, an "AFFILIATE" of any specified Person means any other Person, directly or indirectly, controlling or controlled by or under direct or indirect common control with such specified Person. For the purposes of this definition, "control" when used with respect to any Person means the power to direct the management and policies of such Person, directly or indirectly, whether through the ownership of voting securities, by contract or otherwise; and the terms "controlling " and "controlled" have meanings correlative to the foregoing. For purposes of this PARAGRAPH 13 only, "Affiliate" shall also mean any beneficial owner of Capital Stock representing 5% or more of the total voting power of the voting stock (on a fully diluted basis) of Holdings or of rights or warrants to purchase such Capital Stock (whether or not currently exercisable) and any

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Person who would be an Affiliate of any such beneficial owner pursuant to the first sentence hereof.

14. ASSET DISPOSITIONS. Maker will not, and will not permit Holdings to, sell, lease, assign, transfer or otherwise dispose of any of its property, except (a) dispositions of inventory in the ordinary course of business, (b) dispositions of property no longer used or useful in the ordinary course of business, (c) transfers of fiber capacity in exchange for indefeasible rights of use, and (d) long-term leases of fiber capacity; provided, however, that Maker or Holdings may sell, lease, assign, transfer or otherwise dispose of up to an aggregate of $5,000,000 of property (not including dispositions of

property permitted by clauses (a) through (d) of this PARAGRAPH 14) as long as (i) no Event of Default has occurred and is continuing and (ii) Maker or Holdings receives consideration for the disposition of the property at least equal to the fair market value of the property as determined in good faith by the board of directors of Maker or Holdings, as the case may be.

15. PREPAYMENT OF OTHER DEBT. Maker will not, and will not permit Holdings to, directly or indirectly make any payment or distribution on account of, or voluntarily purchase, acquire, redeem or retire, any indebtedness of any type or nature, including any contingent obligations, prior to 30 days before its stated maturity (in effect on the date hereof, for indebtedness outstanding on the date hereof), or in the case of interest, its stated due date, or directly or indirectly become obligated to do any of the foregoing by amending the terms thereof or otherwise without Payee's prior written consent, except for (a) prepayments of the indebtedness evidenced by this Note, and (b) payments of accounts payable in the ordinary course of business.

16. EVENTS OF DEFAULT AND REMEDIES. Without notice or demand (which are hereby waived), the entire unpaid principal balance of, and all accrued but unpaid interest on, this Note shall immediately become due and payable at the option of the holder hereof upon the occurrence and during the continuance of any Event of Default. The occurrence of any one or more of the following shall constitute an Event of Default hereunder (each an "EVENT OF DEFAULT"): (a) a failure by Maker to make any payment of principal or interest on this Note or any other payment required of Maker hereunder when due; (b) Maker shall fail to observe or perform any obligation, requirement, covenant or restriction to be observed or performed by it under this Note (other than a payment described in SUBPARAGRAPH (A) above) and such failure continues for a period of thirty (30) days; (c) the representation and warranty made by Maker to Payee in PARAGRAPH 10 hereof or any representation or warranty made by Maker to Payee in the officer's certificate furnished to Payee in connection herewith shall be false, misleading, incorrect or incomplete in any material respect; (d) the appointment of a receiver, trustee, conservator, or liquidator of Maker or Holdings or any property of Maker or Holdings which is not dismissed within sixty (60) days after its filing; (e) a filing by Maker or Holdings of a voluntary petition

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seeking an entry of an order for relief as a debtor in a proceeding under the United States Bankruptcy Code or seeking reorganization or rearrangement or taking advantage of any bankruptcy, insolvency, liquidation, conservatorship, receivership, moratorium, rearrangement, reorganization or other similar law for the relief of debtors, or an answer by Maker or Holdings admitting the material allegations of a petition filed against Maker or Holdings in any bankruptcy, reorganization, insolvency, conservatorship, or similar proceeding, or an admission by Maker or Holdings in writing of an inability to generally pay its debts as they become due; (f) the making by Maker or Holdings of a general assignment for the benefit of creditors; (g) the filing of a petition or entry of an order for relief by or against Maker or Holdings as debtor in a proceeding under the United States Bankruptcy Code by any court of competent jurisdiction, or approving a petition seeking reorganization of Maker

or Holdings or an arrangement of their respective debts, or appointing a receiver, trustee, conservator, or liquidator of Maker or Holdings or any property of Maker or Holdings not dismissed within thirty (30) days after filing; (h) the liquidation, termination, or dissolution of Maker or Holdings; (i) if the validity or enforceability of this Note shall be contested by Maker or Holdings, or if Maker shall deny that it has any further liability or obligation hereunder; (j) Maker or Holdings shall fail to pay any indebtedness greater than $5,000,000 due any third person and such failure continues beyond any applicable grace period; (k) Maker or Holdings shall suffer a final judgment or judgments not covered by insurance for payment of money aggregating in excess of $5,000,000 and shall not discharge such judgment(s) within sixty (60) days; (l) any default or event of default occurs with respect to any indebtedness for borrowed money or any lease agreement for which Maker or Holdings has liability in excess of $5,000,000 and is not cured within any applicable grace period; (m) Maker shall be in material breach of any material provision of the NPPA or any default or event of default shall exist under the NPPA, which is not cured within any applicable grace period; or (n) the occurrence of a Change in Control. As used in this Note, a "CHANGE IN CONTROL" means the existence or occurrence of any of the following: (i) any Person other than Holdings owns any of the capital stock of Maker; (ii) any "person" (as such term is used in Sections 13(d) and 14(d) of the Securities Exchange Act of 1934 (the "EXCHANGE ACT")), other than one or more of Central Maine Power Company, a Maine corporation, and its Affiliates, and Northeast Utilities, a Massachusetts business trust, and its Affiliates (together, the "PERMITTED HOLDERS"), is or becomes the beneficial owner (as defined in Rules 13d-3 and 13d-5 under the Exchange Act), except that for purposes of this clause (ii) such person shall be deemed to have "beneficial ownership" of all shares that such person has the right to acquire, whether such right is exercisable immediately or only after the passage of time), directly or indirectly, of more than 35% of the total voting power of the voting stock of Holdings; provided, however, that the Permitted Holders beneficially own (as defined in Rules 13d-3 and 13d-5 under the Exchange Act), directly or indirectly, in the aggregate a lesser percentage of the total voting power of the voting stock of Holdings than such other person

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and do not have the right or ability by voting power, contract or otherwise to elect or designate for election a majority of the Board of Directors of Holdings (for the purposes of this clause (ii), such other person shall be deemed to beneficially own any voting stock of a specified corporation held by another Person (a "PARENT CORPORATION"), if such other person is the beneficial owner (as described in this clause (ii)), directly or indirectly, of more than 35% of the voting power of the voting stock of such Parent Corporation and the Permitted Holders beneficially own (as described in this clause (ii)), directly or indirectly, in the aggregate a lesser percentage of the voting power of the voting stock of such Parent Corporation and do not have the right or ability by voting power, contract or otherwise to elect or designate for election a majority of the board of directors of such Parent Corporation); (iii) individuals who, on the date this Note is executed (the "EXECUTION DATE"), constituted the Board of Directors of Holdings (together with any new directors whose election by such Board of Directors of Holdings or whose nomination for election by the shareholders of Holdings was approved by a vote of 66-2/3% of the directors of Holdings then still in office who were either directors on the

Execution Date or whose election or nomination for election was previously so approved) cease for any reason to constitute a majority of the Board of Directors of Holdings then in office; (iv) the adoption of a plan relating to the liquidation or dissolution of Holdings; or (v) the merger or consolidation of Holdings with or into another Person or the merger of another Person with or into Holdings, or the sale of all or substantially all the assets of Holdings to another Person (other than a Person that is controlled by the Permitted Holders), and, in the case of any such merger or consolidation, the securities of Holdings that are outstanding immediately prior to such transaction and which represent 100% of the aggregate voting power of the voting stock of Holdings are changed into or exchanged for cash, securities or property, unless pursuant to such transaction such securities are changed into or exchanged for, in addition to any other consideration, securities of the surviving Person or transferee that represent immediately after such transaction, at least a majority of the aggregate voting power of the voting stock of the surviving Person or transferee. Upon the occurrence of an Event of Default, the holder of this Note may (i) offset against this Note any sum or sums owed by the holder hereof to Maker, (ii) proceed to protect and enforce its rights either by suit in equity and/or by action at law, or by other appropriate proceedings, whether for the specific performance of any covenant or agreement contained in this Note, or in aid of the exercise of any power or right granted by this Note, or to enforce any other legal or equitable right of the holder of this Note, and/or (iii) pursue the remedies available to Payee hereunder, at law and otherwise.

17. ATTORNEY'S FEES AND COSTS. In the event this Note is placed in the hands of an attorney for collection, or in the event this Note is collected in whole or in part through legal proceedings of any nature, Maker promises to pay all costs of collection, including, but not limited to, attorneys' fees incurred by the holder hereof on account of such collection, whether or not suit is filed.

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18. CUMULATIVE RIGHTS. No delay on the part of the holder of this Note in the exercise of any power or right under this Note, or under any other instrument executed pursuant hereto, shall operate as a waiver thereof, nor shall a single or partial exercise of any such power or right. Enforcement by the holder of this Note of any security for the payment hereof shall not constitute any election by it of remedies so as to preclude the exercise of any other remedy available to it.

19. MAXIMUM INTEREST RATE. Regardless of any provision contained herein, or in any other document executed in connection herewith, Payee shall never be entitled to contract for, charge, receive, take, collect, reserve or apply, as interest on this Note, any amount in excess of the maximum rate of interest from time to time permitted under state or federal law applicable to the indebtedness evidenced hereby, after taking into account any amount, fee or charge which is characterized as interest under applicable law (the "MAXIMUM LAWFUL RATE"), and in the event Payee ever contracts for, charges, receives, takes, collects, reserves or applies, as interest, any such excess, such amount which would be deemed excessive interest shall be deemed a partial prepayment of

principal on this Note and treated hereunder as such; and, if this Note is paid in full, any remaining excess shall promptly be paid to Maker. In determining whether the interest paid or payable, under any specific contingency, exceeds the Maximum Lawful Rate, Maker and Payee shall, to the maximum extent permitted under applicable law, (a) characterize any nonprincipal payment as an expense, fee or premium rather than as interest, (b) exclude voluntary prepayments and the effects thereof, and (c) amortize, prorate, allocate and spread, as appropriate to reflect variations in the Maximum Lawful Rate, the total amount of interest throughout the entire contemplated term of this Note, so that the interest rate does not exceed the Maximum Lawful Rate throughout the entire term of this Note; PROVIDED THAT, if the unpaid principal balance hereof is paid and performed in full prior to the end of the full contemplated term hereof, and if the interest received for the actual period of existence thereof exceeds the Maximum Lawful Rate, Payee shall refund to Maker the amount of such excess and, in such event, Payee shall not be subject to any penalties provided by any laws for contracting for, charging, receiving, taking, collecting, reserving or applying interest in excess of the Maximum Lawful Rate. Upon the tender by Payee or any holder of this Note to Maker of any excess amount, Maker will be deemed to have accepted such excess in full satisfaction of any claim (including, without limitation, a claim of usury) arising out of such excess being contracted for, charged, received, taken, collected, reserved or applied.

20. WAIVER. Maker, and each surety, endorser, guarantor, and other party ever liable for the payment of any sum of money payable on this Note, jointly and severally waive notice, demand, presentment, protest, notice of protest, notice of nonpayment, notice of dishonor, notice of intention to accelerate, notice of acceleration, and any and all lack of diligence or delay in collection or the filing of suit hereon which may occur, and agree that their

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liability on this Note shall not be affected by any renewal or extension in the time of payment hereof, by any indulgences, or by any release, impairment or change in any security for the payment of this Note, and hereby consent to any and all renewals, extensions, indulgences, releases, or changes (including partial payments), regardless of the number of such renewals, extensions, indulgences, releases or changes, without notice and for any period or periods of time, before or after maturity, all without prejudice to the holder. The holder shall similarly have the right to deal in any way, at any time, with one or more of the foregoing parties without notice to any other party, and to grant any such party any extensions of time for payment of any of said indebtedness, or to release or substitute part or all of the collateral (if any) securing this Note, or to grant any other indulgences or forbearances whatsoever, without notice to any other party and without in any way affecting the personal liability of any party hereunder.

21. SUCCESSORS AND ASSIGNS. All of the covenants, stipulations, promises and agreements in this Note by or on behalf of Maker shall bind Maker's respective successors and assigns, whether so expressed or not; PROVIDED, HOWEVER, that Maker may not, without the prior consent of Payee, assign any rights, powers, duties, or obligations under this Note. Any holder of this Note shall succeed to the rights of Payee hereunder. Payee may sell, transfer or assign its rights hereunder and to the Collateral in whole or in

part at any time and from time to time without the consent of Maker, PROVIDED, HOWEVER, that unless an Event of Default has occurred and is continuing, Payee may not, without the prior written consent of Maker, sell, transfer or assign its rights hereunder and to the Collateral in whole or in part to any individual or entity that is engaged in a business competitive with that of Maker.

22. INVALID PROVISIONS. Any provision in this Note prohibited by law shall be ineffective only to the extent of such prohibition and shall not invalidate the remainder of this Note.

23. GOVERNING LAW. THIS NOTE SHALL BE GOVERNED BY AND CONSTRUED IN ACCORDANCE WITH THE LAWS OF THE STATE OF NEW YORK, WITHOUT GIVING EFFECT TO THE CONFLICT OF LAWS PROVISIONS THEREOF, AND APPLICABLE FEDERAL LAW.

24. NOTICES. All notices and other communications provided for in this Note shall be given or made by telecopy or in writing and telecopied, mailed by certified mail return receipt requested, or delivered to the intended recipient at the "Address for Notices" specified below Maker's name on the signature pages hereof or if to Payee at GMS 991-15-A40, 2221 Lakeside Boulevard, Richardson, Texas 75082-4399, Attention: Vice President Customer Finance Americas, telephone no.: 972-684-2271, fax no.: 972-684-3679; or, as to any party at such other address as shall be designated by such party in a notice to the other party given in accordance with this PARAGRAPH 24. All such communications shall be deemed to have been duly given when transmitted by telecopy or when personally

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delivered or, in the case of a mailed notice, three Business Days after deposit in the mails, in each case given or addressed as aforesaid; PROVIDED, HOWEVER, that notices to the Payee shall be deemed given when received by the Payee. As used herein, "BUSINESS DAY" means any day on which Payee is open for its general business at its offices in the United States.

25. HEADINGS. The headings of the sections of this Note are inserted for convenience only and shall not be deemed to constitute a part hereof.

26. PAYMENTS; BUSINESS DAY. Each payment or prepayment hereon must be paid at the office of Payee specified above in lawful money as therein specified and in funds which are or will be available for immediate use by Payee at such office on or before 3:00 p.m., Eastern time on the day such payment or prepayment is due. If a payment of principal or interest hereon is due on a day which is not a Business Day, Maker shall make such payment on the next preceding Business Day.

27. STATUTE OF FRAUDS NOTICE. THIS NOTE REPRESENTS THE FINAL AGREEMENT OF MAKER AND PAYEE AND MAY NOT BE CONTRADICTED BY EVIDENCE OF PRIOR, CONTEMPORANEOUS, OR SUBSEQUENT ORAL AGREEMENTS OF MAKERS AND PAYEE. THERE ARE NO UNWRITTEN ORAL AGREEMENTS BETWEEN MAKER AND PAYEE.

28. WAIVER OF JURY TRIAL. TO THE FULLEST EXTENT PERMITTED BY APPLICABLE LAW, MAKER AND EACH SURETY, ENDORSER, GUARANTOR, AND OTHER PARTY EVER LIABLE FOR THE PAYMENT OF ANY SUM OF MONEY PAYABLE ON THIS NOTE, HEREBY IRREVOCABLY AND EXPRESSLY AND JOINTLY AND SEVERALLY WAIVE ALL RIGHT TO A TRIAL BY JURY IN ANY ACTION, PROCEEDING OR COUNTERCLAIM (WHETHER BASED UPON CONTRACT, TORT OR OTHERWISE) ARISING OUT OF OR RELATING TO THIS NOTE OR THE TRANSACTIONS CONTEMPLATED HEREBY OR THE ACTIONS OF PAYEE IN THE NEGOTIATION, ADMINISTRATION OR ENFORCEMENT HEREOF.

EXECUTED at New York, New York, as of August 14 , 2001.

NEON OPTICA, INC.

By: /s/ WILLIAM F. FENNELL

Name: WILLIAM F. FENNELL
Title: CHIEF FINANCIAL OFFICER AND TREASURER

ADDRESS FOR NOTICES:

2200 West Park Drive, Suite 200
Westborough, Massachusetts 01581
Fax No.: (508) 616-7895
Telephone No.: (508) 616-7820

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Attention: Chief Financial Officer

SCHEDULE 9

Existing Debt

See Attached.

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