CT HOLDINGS INC
Form 10QSB
May 20, 2002

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

FORM 10-QSB

(Mark One)

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

For The Quarterly Period Ended March 31, 2002

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

For The Transition Period From _________ To _________

Commission File Number: 0-08718

CT HOLDINGS, INC.
(Exact Name of Small Business Issuer As Specified In Its Charter)

DELAWARE	75-2432001
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

8750 N. CENTRAL EXPRESSWAY, SUITE 100,
DALLAS, TX 75231
(Address of Principal Executive Offices)

(214) 520-9292
(Issuer's Telephone Number)

Indicate by check mark whether the issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months(or for such shorter period 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 [ ]

Indicate the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date.

Class	Outstanding at May 16, 2002
Common Stock, Par value $.01 per share	58,320,414

Transitional Small Business Disclosure Format Yes [ ] No [X]

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CT HOLDINGS, INC.

FORM 10-QSB
Quarterly Period Ended March 31, 2002

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

CT HOLDINGS, INC.
BALANCE SHEETS

	March 31, 2002 (unaudited)	December 31, 2001
ASSETS		
INVESTMENT IN UNCONSOLIDATED AFFILIATES	$ 2,735,975	$ 2,735,975
NET LONG-TERM ASSETS OF DISCONTINUED OPERATIONS	358,377	241,767
	$ 3,094,352	$ 2,977,742

LIABILITIES AND STOCKHOLDERS' (DEFICIT) EQUITY

CURRENT LIABILITIES		
Accounts payable and accrued expenses	$ 1,242,999	$ 911,333
Advances and notes payable to related parties	600,396	540,330
Convertible note payable to shareholder	300,000	--
Net current liabilities of discontinued operations	1,551,074	935,693
Total current liabilities	3,694,469	2,387,356
COMMITMENTS AND CONTINGENCIES (NOTE D)		
STOCKHOLDERS' (DEFICIT) EQUITY		
Preferred stock - $.01 par value; 1,000,000 shares authorized; no shares issued or outstanding at March 31, 2002 and December 31, 2001		
Common stock - $.01 par value; 60,000,000 shares authorized; 54,006,721 and 53,994,221 shares issued at March 31, 2002 and December 31, 2001	540,067	539,943
Additional paid-in capital	56,458,775	56,429,100
Accumulated deficit	(55,098,720)	(53,878,418)
Treasury stock at cost (4,164,613 common shares)	(2,500,239)	(2,500,239)
Stockholders' (deficit) equity	(600,117)	590,386
	$ 3,094,352	$ 2,977,742

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

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CT HOLDINGS, INC.
UNAUDITED STATEMENTS OF OPERATIONS

	Three Months Ended March 31, 2002	2001
Revenue	$ --	$ --
General and administrative expenses	454,070	161,440
Interest expense	37,932	4,507
Interest income	--	(21,250)
Loss from continuing operations	(492,002)	(144,697)
Costs in connection with spin off of subsidiary	(158,717)	--
Loss from discontinued operations	(569,582)	(509,779)
Net loss	$(1,220,301)	$ (654,476)
Weighted average common shares outstanding - basic and diluted	49,834,747	49,660,704
Net loss per share - basic and diluted		
Continuing operations	$ (0.01)	$ --
Discontinued operations	(0.01)	(0.01)

	$ (0.02)	$ (0.01)

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

CT HOLDINGS, INC.
UNAUDITED STATEMENTS OF CASH FLOWS

	Three Months Ended March 31,	
	2002	2001
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	$(1,220,301)	$(654,476)
Less net loss from discontinued operations	569,582	509,779
Adjustments to reconcile net loss to net cash used in operating activities:		
Beneficial conversion feature of convertible debt recognized as interest expense	25,650	--
Common stock issued in lieu of cash for services	4,148	--
Changes in operating assets and liabilities		
Other receivables	--	(21,250)
Accounts payable and accrued expenses	331,666	191,357
Payable to affiliate	--	(28,447)
NET CASH USED IN OPERATING ACTIVITIES	(289,255)	(3,037)
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from notes receivable from related parties	--	78,500
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from convertible note payable to shareholder	300,000	--
Proceeds from notes payable from related parties	219,000	--
Payments on notes payable to related parties	(158,934)	--
NET CASH PROVIDED BY FINANCING ACTIVITIES	360,066	--
Net cash provided by continuing operations	70,811	75,463
Net cash used by discontinued operations	(70,811)	(75,463)
Net change in cash	--	--
Cash and cash equivalents at the beginning of the period	--	--
Cash and cash equivalents at the end of the period	$ --	$ --

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

CT HOLDINGS, INC.
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2002
(unaudited)

NOTE A - NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Unaudited Interim Consolidated Financial Statements

The accompanying unaudited interim consolidated financial statements reflect, in the opinion of management, all adjustments (consisting of normal, recurring adjustments) necessary to present fairly the financial position, results of operations and cash flows of CT Holdings. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States ("GAAP") have been condensed or omitted pursuant to rules and regulations promulgated by the Securities and Exchange Commission (the "SEC"). These statements should be read together with the audited financial statements and notes thereto for the years ended December 31, 2001 and the ten months ended December 31, 2000, included in CT Holdings' Form 10-KSB for the fiscal year ended December 31, 2001 on file with the Commission. The results of operations for the interim periods shown herein are not necessarily indicative of the results to be expected for any future interim period or for the entire year.

All material intercompany transactions with its consolidated subsidiary and unconsolidated affiliates have been eliminated pursuant to the applicable accounting principles for consolidation and the equity method of accounting. The balance sheet, results of operations and the cash flows of the Company's wholly owned subsidiary, Citadel Security Software Inc. are presented as discontinued operations due to the planned Distribution discussed under Citadel Security Software Distribution. Where appropriate, prior year amounts have been reclassified to conform to the current period presentation

Nature of Business

CT Holdings, Inc. (the "Company" or "CT Holdings") provides management expertise including consulting on operations, marketing and strategic planning and a source of capital to early stage technology companies. The Company previously operated under the name Citadel Technology Inc. and was incorporated in Delaware in 1992. At March 31, 2002 the Company held investments in Citadel Security Software Inc. ("Citadel") a wholly owned subsidiary, Parago Inc. ("Parago"), River Logic Inc. ("River Logic") and Encore Telecommunications, Inc. ("Encore"). The business model is designed to enable the companies with whom the Company acquires or invests to become market leaders in their industries. The strategy over the years has led to the development, acquisition and operation of technology based businesses with compelling valuations and strong business models. The anticipated growth in technology creates strong opportunities to increase shareholder value by investing in early stage ventures well-positioned in their market or holding unique technology. The goal is to realize the value of these investments for the Company's shareholders through a subsequent liquidity event such as a sale, merger, spin-off or initial public offering of the investee companies.

At March 31, 2002 the Company held a 100% investment in Citadel Security Software and in January 2002 filed a registration statement and in March and April 2002 filed amendments to the registration statement with the SEC to spin off Citadel as a separate public company in a pro rata dividend distribution of the common stock of Citadel to CT Holdings' shareholders. (See the Citadel Security Software Distribution below.) The registration statement is effective and the distribution of shares in Citadel will occur on or about May 17, 2002.

While Citadel operates its security software business as a stand-alone company, the assets, liabilities, revenue and expense, previously consolidated with the financial statements of the Company are presented in these financial statements as discontinued operations at March 31, 2002 and for the three months ended March 31, 2002 and 2001.

Citadel develops, markets and licenses its product line of desktop and network security software products that address security inside the firewall, a growing segment within the software industry. The Company's security software products are generally licensed for perpetual use on standalone personal computers or on single or multiple networks, across single or multiple customer computing sites. Citadel's software products, Hercules, WinShield Secure PC and NetOFF, provide the flexibility and scalability that security administrators demand for automating the remediation of security vulnerabilities and for managing security policies within computing environments.

These security software tools operate inside the firewall and are designed to secure computers and networks against unauthorized configuration changes, unapproved software installations and other causes of security vulnerabilities in computing systems.

Parago was formed in 1999 as an application service provider ("ASP") and Internet based business process outsourcer that provides an online suite of offerings designed to increase sales, reduce costs, retain customers and increase client profitability. These services include online promotional management, online rebate processing, proactive email, online surveys, and customer data warehousing, analysis and reporting. Parago's comprehensive integrated suite of outsourced customer care solutions are marketed across multiple industry lines.

During 2001 the Company's percentage ownership in Parago was reduced to approximately 1% as a result of an additional private equity financing by Parago begun in December 2001 and completed in February 2002 in which the Company chose not to participate. The Company's investment in Parago had been accounted for using the equity method through December 12, 2001, the date of the first closing of the financing. Subsequent to the this financing, the Company's investment has been accounted for using the cost method.

In May 2000, CT Holdings acquired a minority interest in River Logic, which develops decision-support applications for industry. Using a technology developed by River Logic known as COR Technology, a rapid-application development system, developers at River Logic create applications that enable industry professionals to model complex enterprises and explore financial relationships on a desktop computer or laptop. Embedded analytics allow end-users to understand the financial implications of critical business decisions easily by manipulating graphical icons that model their enterprise. The Company holds approximately 12% of River Logic and accounts for its investment in River Logic using the cost method.

The Company also holds a small minority investment in Encore Telecommunications Inc. following the restructure of a loan the Company made to an entity whose assets were acquired by Encore.

Citadel Security Software Distribution

In November 2001, the board of directors of CT Holdings approved the spin-off of Citadel through the declaration of a pro rata dividend distribution to the holders of record of the outstanding shares of CT Holdings common stock (the "Distribution"). The Distribution consists of one (1) share of Citadel common stock for every four (4) shares of CT Holdings (the "Distribution Ratio") held by CT Holdings shareholders as of May 6, 2002 (the "Record Date). Following the Distribution on May 17, 2002 (the "Distribution Date"), Citadel will be an independent company and CT Holdings will have no continuing ownership interest in Citadel. The Distribution is intended to be a tax free distribution for U.S. federal tax purposes. On the Distribution Date, CT Holdings and Citadel will enter into a series of agreements including a distribution agreement, a transition services agreement, an indemnity agreement and a tax disaffiliation agreement which will provide for, among other things, the principal corporate transactions required to effect the Distribution, to provide for an orderly transition to the status of two independent companies and to define the continuing relationship between Citadel and CT Holdings after the Distribution.

Liquidity

The Company has incurred recurring operating losses and has a significant working capital deficiency at March 31, 2002. Cash used in operations was approximately $289,000 during the three months ended March 31, 2002. The Company had no cash balance at March 31, 2002 and current liabilities from continuing operations exceed current assets from continuing operations by approximately $2.1 million. Immediate funding needs of the business are expected to be provided by financings through short-term notes payable and additional investments from related parties.

In May 2002 the Company negotiated the settlement of approximately $826,000 of operating liabilities in exchange for 1,575,000 shares of common stock of the Company. The creditors associated with these liabilities are shareholders of record on the Record Date and will receive the dividend of the Citadel common stock to be distributed on or about May 17, 2002. The settlement transactions will be accounted for pursuant to FAS 15 -

Accounting for Debtors and Creditors for Troubled Debt Restructurings and accordingly a net gain or loss on the restructuring of payables representing the difference between the fair value of the Company's common stock issued and the recorded value of the liability will be recorded. This gain of approximately $433,000 will be recorded during the second quarter of 2002. The fair value of the Company's common stock has been determined as the closing price ($0.25) on May 1, 2002, the day before the ex-dividend date, the last day the Company's common stock was traded and quoted with the value of the dividend included.

The Company has been and continues to be dependent upon outside financing to perform its business development activities, make investments in new technology companies and to fund operations. During the quarter ended March 31, 2002, related parties provided substantially all of this financing. Future cash may come from the realization of the value of our investments in Parago, River Logic and Encore, although there can be no assurance that any value will ever be realized from these investments.

The Company's strategy of continuing to support and expand its business development activities will not generate positive cash flow in the foreseeable future. The complete implementation of this element of this strategy requires the Company to obtain additional capital. Achieving positive cash flow is currently highly dependent upon obtaining liquidity from the Company's investments in unconsolidated affiliates. The Company estimates it will need to raise $500 thousand to $1 million to support its incubator and business development activities through the remainder of 2002. Historically, the Company has obtained short-term bridge funding from its Chief Executive Officer or Directors of the Company. While this may occur in the future there can be no assurance that such financing will be available or if available with terms that the Company would be willing to accept.

The Company has made investments in entities that it believes may provide liquidity to the Company in the long term. The Company believes that its investment in Parago has been successful with Parago having had no revenue at the time of the Company's initial $50,000 equity investment, growing to net revenue of approximately $26 million for the year ended December 31, 2001. As expected in an early stage company, Parago has not been profitable and has experienced cash flow deficiencies as it implements its business plan. During 2001 the Company's percentage ownership in Parago was reduced to approximately 1% as a result of an additional equity financing raised by Parago in December 2001. The Company believes, however, that its remaining investment of 20,000 common shares of Parago (following a 1-for-1000 reverse stock split) and warrants to purchase 28.8749 shares of Series A-3 preferred stock (convertible into 2,887 shares of common stock) may ultimately provide an appropriate return.

Similarly, the Company believes its investment in River Logic has also been successful. Since the initial investment, River Logic has made progress in executing its strategy through its development and introduction of new products and establishment of new customer relationships. In addition, during April, 2001 River Logic obtained a significant strategic investment from the Intel 64 Fund, Cardinal Investments, eMed Ventures, and Mercury Ventures. Similar to the investments in Parago, the Company recognized that this investment would be initially illiquid. The Company's minority position in Encore is immaterial and is not expected to provide liquidity to the Company in the foreseeable future. While the Company is pleased with the performance of its investee companies to date, there can be no assurance that the Company will ever achieve liquidity for its investments.

There can be no assurance that management's plans will be successful or what other actions may become necessary. Until the Company is able to create liquidity from its investments through sale to a strategic investor, an initial public offering or some other liquidity transaction, the Company will continue to require working capital to fund its own operating expenses. Although the Company has been successful raising capital in the past, the inability of the Company to raise capital may require the Company to sell assets or reduce the level of its operations. Such actions could have a material adverse effect on the Company's business and operations and result in charges that could be material to the Company's business and results of operations.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2002
(unaudited)

management to make estimates and assumptions that affect the amounts reported in the financial statements. Actual results could differ from those estimates.

Investment in Unconsolidated Affiliates

The Company holds investments in three unconsolidated affiliate companies, Parago, River Logic, and Encore. The Company records its investments under the equity method or the cost method of accounting as applicable, and presents its investments in these companies on its balance sheets as Investment in Unconsolidated Affiliates and its share of the equity-method investee's losses, if applicable, on the statements of operations as Equity in Loss of Unconsolidated Affiliate. All significant intercompany accounts and transactions have been eliminated.

After a 1 for 1000 reverse stock split the Company holds 20,000 shares of common stock of Parago and warrants to purchase 28.8749 shares of Series A-3 preferred stock (convertible into 2,887 shares of common stock) at March 31, 2002. In December 2001 Parago completed an equity financing of approximately $13.6 million of a total $15 million financing. Approximately $1.4 million of equity financing was closed in February 2002. As a result of the equity financing the Company's ownership percentage in Parago was reduced to approximately 1%. The Company's investment in Parago for the period from January 1, 2001 through December 12, 2001 was accounted for under the equity method of accounting for investments and accordingly as a result of the Company's ownership falling below 20%, has been accounted for using the cost method of accounting for equity investments beginning December 13, 2001. Under the cost method, the Company's share of income or loss of Parago is not included in the Company's statements of operations. Under the equity method of accounting, the Company's share of the investee's income or losses is included in the statements of operations. If the carrying value of the Company's net investment falls below zero, as it did during the ten months ended December 31, 2000, the Company discontinues applying the equity method until the carrying value of the net investment rises above zero. In addition, in the event the Company's ownership percentage exceeds 20% and the value of the Company's equity investment rises above zero, the Company will resume applying the equity method and will recognize an investment in Parago after the Company's share of net losses not recognized is recovered through its proportionate share of net income if Parago turns profitable.

During the second quarter of 2001 the Company, along with other investors in Parago, participated in a bridge loan financing of Parago in the amount of $692,740 and guaranteed $1,406,472 of a bank term loan to Parago. In accordance with Accounting Principles Board Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock the Company recognized a charge to earnings of $2,099,212 in June 2001. Upon closing of the Parago Equity Financing in December 2001 Parago repaid the bridge loan and the bank guarantee was released. As a result the Company reversed the $2,099,212 in the fourth quarter of 2001.

As the Company owned less than 20% of the ownership interest in River Logic at March 31, 2002 and December 31, 2001 the investment has been accounted for under the cost method of accounting equity investments. Under this method, the Company's share of the income or losses of River Logic is not included in the Company's statements of operations. The Company's investment in River Logic is $2,703,975 at March 31, 2002 and December 31, 2001, respectively.

The Company's investment in Encore is approximately $32,000 and is accounted for under the cost method of accounting for equity investments.

The Company periodically evaluates the investments in its investee companies for impairment based upon the prospects of the entity and the value of the investment when compared to other investments in the entity from other unrelated parties. If these factors indicate that an other than temporary impairment exists, then the Company will write down the value of the investment to its realizable value. At December 31, 2001 the Company determined that a write-down of $360,000 in its investment in River Logic was necessary based on the value ascribed to River Logic financing transactions during 2001. The investment in Parago was written down to zero during 2000 through the accounting for equity losses.

Impairment of Long-Lived Assets

In accordance with Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the Company reviews its long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable and exceeds its fair value. If conditions indicate an asset might be impaired, the Company estimates the future cash flows expected to result from the use of the asset and its eventual disposition. The impairment would be measured by the amount by which the asset exceeds its fair value typically represented by the future discounted cash flow associated with the asset.

Stock-Based Compensation

The Company has elected to account for stock-based compensation to employees using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ("APB 25") and related interpretations. Accordingly, compensation cost for stock options is measured as the excess, if any, of the fair market value of the Company's stock at the date of the grant over the amount an employee must pay to acquire the stock.

The Company accounts for equity instruments issued to non-employees in accordance with the provisions of SFAS No. 123 and Emerging Issues Task Force ("EITF") Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services." All transactions in which goods or services are the consideration received for the issuance of equity instruments are accounted for based on the fair value of the consideration received or the fair value of the equity instrument issued, whichever is more reliably measurable. The measurement date of the fair value of the equity instrument issued is the earlier of the date on which the counterparty's performance is complete or the date on which it is probable that performance will occur.

Net Loss Per Common Share

Basic loss per common share is computed by dividing net loss by the weighted average number of shares of common stock outstanding during the period. Basic loss per share excludes any dilutive effects of options. Stock options and warrants to purchase shares of common stock have been excluded from the computation of diluted loss per share, as the effect would be anti-dilutive.

NOTE B - DISCONTINUED OPERATIONS

In January 2002, Citadel filed a registration statement with the SEC related to the pro rata dividend distribution of the shares of Citadel held by the Company to the shareholders of CT Holdings. (See Citadel Security Software Distribution in Note A) The unaudited results of operations for the quarter ended March 31, 2002 and 2001 are as follows:

	Quarter Ended March 31, 2002	2001
Revenue	$ 89,276	$ 100,707
Costs of revenue	2,092	1,146
Software amortization	5,000	189,060
Total costs of revenue	7,092	190,206
Selling, general and administrative expenses	594,162	390,112
Research and development expenses	40,675	--
Depreciation expense	16,929	30,168
Total operating expenses	651,766	420,280
Operating loss	(569,582)	(509,779)
Provision for income taxes	--	--

CT HOLDINGS, INC.
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2002
(unaudited)

Net loss	$(569,582)	$(509,779)

At March 31, 2002 and December 31, 2001 the net current liabilities and the net long-term assets of Citadel were as follows:

	March 31, 2002 (unaudited)	December 31, 2001
Current assets		
Cash and cash equivalents	$ 11,867	$ 75,030
Accounts receivable, net	46,378	24,222
Prepaid expenses	76,188	72,702
Total current assets	134,433	171,954
Current liabilities		
Accounts payable and accrued expenses	1,292,555	862,262
Payroll tax obligations	378,400	245,385
Deferred revenue	14,552	--
Total current liabilities	1,685,507	1,107,647
Net current liabilities of discontinued operations	$1,551,074	$ 935,693

Property and equipment, net	$ 40,849	$ 43,006
Capitalized software development costs, net	300,285	174,110
Other assets	17,243	24,651
Net long-term assets of discontinued operations ...	$ 358,377	$ 241,767

NOTE C - RELATED PARTY TRANSACTIONS

During the quarter ended March 31, 2002 the Company borrowed $300,000 from a stockholder and in April borrowed an additional $300,000. On April 1, 2002 the Company entered into a non interest bearing convertible note payable with this stockholder for $600,000. The note expires on April 1, 2003 and is convertible into 2,700,000 shares of CT Holdings common stock. If converted after the Record Date of the Distribution of Citadel the note is convertible into 675,000 shares of common stock of Citadel in addition to 2,700,000 shares of the Company's common stock. Pursuant to EITF 98-5 "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios" interest expense of $25,650 representing the beneficial conversion feature associated with the principal outstanding at March 31, 2002 has been recorded with an offset to additional paid-in-capital.

Two other shareholders advanced the Company $219,000 of which $150,000 was repaid by the Company during the quarter ended March 31, 2002. The remaining outstanding balances of $49,000 and $20,000, to these shareholders at March 31, 2002 were converted into short term notes payable each bearing interest at 8% per annum and due June 30, 2002.

At March 31, 2002 the Company holds a $250,000, 8% note payable to a director due April 30, 2002 plus accrued interest of $10,000. The Company is negotiating an extension of the note. At March 31, 2002 the Company has a liability $281,396 to the CEO of the Company for advances made to fund operations during 2001. No advances were made to the Company by the CEO during the first quarter of 2002.

During the quarter ended March 31, 2002 the Company incurred $ 107,775 of legal fees to an attorney who is a former employee and a relative of the Company's CEO. Part of these fees will be settled through the issuance of 250,000 shares of the Company's common stock during the second quarter of 2002 and the remainder of $45,275 will be settled in cash. At March 31, 2002 the Company has $168,009 in liabilities accrued for services from this attorney. In the quarter ended March 31, 2001

no fees or amounts outstanding were incurred or recorded from this attorney. Another shareholder will receive 250,000 shares of the Company's common for consulting with the Company in the first quarter of 2002. These services valued at $62,500 will be paid in common stock during the second quarter of 2002. The Company incurred fees of $36,250 related to services performed by a consultant in the first quarter of 2002 prior to becoming employed as its Chief Financial Officer. Of this amount $11,250 will be settled through the issuance of 37,500 shares of common stock of the Company and the remainder of $25,000 in cash.

During May 2002 the Company sold 100,000 restricted shares of common stock for $25,000. In connection with an acquisition by Parago in 1999 the Company agreed to exchange up to 500,000 shares of the Company's common stock for shares of Parago common stock at the option of the stockholders of the company acquired by Parago. In addition, pursuant to the terms of the subscription agreements between Parago and some of its stockholders, the Company may be required to issue up to 414,000 shares of its common stock to such holders based upon a conversion price of $3.75 per share. In May 2002 the Company exchanged 155,806 shares of the Company's common stock for 1,240 shares of common stock of Parago as a result of these conversion features.

Also in May 2002 the Company issued 6,500,000 shares of the Company's common stock pursuant to the exercise of stock options in return for $1,307,500 in promissory notes to the Company secured by the shares issued to the option holders. In addition, 147,500 shares of the Company's common stock were issued to option holders as a bonus in lieu of payment of $29,500 for the exercise price for those options.

NOTE D - COMMITMENTS AND CONTINGENCIES

In August 1998, Janssen-Meyers Associates L.P. (JMA) filed a lawsuit against the Company arising out of an alleged 1995 contract with the Company's predecessor (Old Citadel). The suit alleged that Old Citadel breached a letter of intent dated September 1995 and/or a Placement Agency Agreement dated November 1995 between JMA and Old Citadel. As its damages, JMA claimed that it was entitled to, among other things, the cash value of warrants to purchase 1.8 million shares of CT Holdings common stock at an exercise price of $0.89 per share, valued during May 1996. According to JMA's valuation of those warrants, potential damages were alleged to exceed $40 million. The Company vigorously disputes that it breached either the letter of intent or the Placement Agency Agreement or that it is liable to JMA. The lawsuit was styled Janssen-Meyers Associates, L.P. v. Citadel Technology, Inc., and was filed in the Supreme Court of the State of New York, County of New York. The Company removed the case to federal court in the Southern District of New York.

Following mediation in July 2000, the Company entered into a settlement term sheet, to attempt to resolve the disputes between it and JMA, pursuant to which the Company and JMA agreed in principle to settle the lawsuit for an aggregate of $3 million, in a combination of $1.5 million in cash and 300,000 shares of the Company's common stock with a guaranteed value of $5 per share as of January, April and October 2001 (with respect to 100,000 of the shares for each period). The settlement was subject to execution of definitive settlement documents and approval of the boards of directors of both parties. As a result, the Company recorded approximately $1,912,500 ($1.5 million in cash and 300,000 shares of the Company's Common Stock at the market price of $1.375 per share) as a nonrecurring charge related to the settlement of the litigation in the ten months ended December 31, 2000.

However, the Company and JMA were unable to negotiate the final definitive settlement agreement. The case was dismissed in August 2000 without any resolution of this issue. On March 27, 2001, JMA attempted to reopen this matter, but the Court hearing the JMA lawsuit issued a Summary Order denying JMA's motion to enforce the settlement term sheet and confirmed the prior dismissal of the lawsuit. The Court further ruled that JMA would either have to bring an action on the proposed settlement or move to re-open the dismissed case. The Court stated that it did not express any view with respect to the merits of the settlement that brought about the dismissal of the case. There was no activity on the case from March 2001 through August 2001. On August 27, 2001 JMA refiled its lawsuit with a federal court in New York, and the Company filed its motion to dismiss the case because the plaintiffs lacked the required diversity jurisdiction to pursue the claims in federal court. On October 31, 2001 the case was dismissed in federal court. In December 2001, the plaintiffs refiled the lawsuit in the state court seeking to enforce the proposed settlement term sheet. The case was filed in Supreme Court of New York, that state's trial court, in a case styled Roan Meyers v. CT Holdings. Given these events, including the dismissal of the lawsuit and the failure of the plaintiffs to refile a lawsuit for more than one year after the date of the dismissal, the Company, in the year ended December 31, 2001, reversed the nonrecurring charge that the Company had previously recorded related to the settlement of the lawsuit.

In June 2000, CT Holdings was served with a lawsuit filed in state court in Houston, Texas by Michael and Patricia Ferguson for breach of contract, tortious interference and negligence. Specifically, the Fergusons claim that they were damaged when they attempted to exercise warrants during a time when CT Holdings' related registration

statement could not be used and asserted damages between $300,000 and $1,500,000. CT Holdings believes that the claims asserted by the Fergusons are without merit and will vigorously defend the claims. The trial in the case was heard in late April and early May 2002 and the Company is awaiting the court's decision.

In June 2000, Tech Data Corporation filed suit against CT Holdings, alleging a breach of a Software Distribution Agreement ("the Agreement") with CT Holdings. The lawsuit is styled Tech Data Corporation v. Citadel Technology, Inc. (now known as CT Holdings), and was filed in Dallas County Court at Law No. 2. Because CT Holdings was not properly served, Tech Data obtained a default judgment for $101,049. When CT Holdings discovered the default judgment, it filed and won a motion to set aside this judgment. In June 2001, Tech Data properly served CT Holdings. CT Holdings answered and demanded binding arbitration pursuant to the agreement. The parties filed a Joint Motion to Arbitrate in December 2001. The judge granted this motion, and CT Holdings expects that this matter will be referred to binding arbitration in the second quarter of 2002. The Company has recorded a liability of $101,049 at December 31, 2001 and 2000 related to this lawsuit. As part of the Distribution, the Company anticipates that Citadel will assume responsibility for this lawsuit, although there can be no assurance that we will be released from the lawsuit.

At this time, the Company is unable to predict the ultimate outcome of some of these suits, the costs associated with defending the claims and pursuing counterclaims, and monetary compensation awarded, if any. The Company has, when appropriate, recorded its current estimate of the amounts necessary to settle the litigation.

The Company is also involved in other litigation, however the Company does not believe the outcome of such litigation will be material to the Company's financial condition or results of operations.

The Company may become involved in litigation on various matters which are routine in conducting its business. The Company believes that none of these actions, individually or in the aggregate, will have a material adverse effect on its financial position or results of operations, though any adverse decision in these cases or the costs of defending or settling such claims could have a material adverse effect on the Company's operations.

ITEM 2 -MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FORWARD-LOOKING STATEMENTS

The following discussion contains forward-looking statements that involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance, or achievements to be materially different from any future results, levels of activity, performance, or achievements expressed or implied by such forward-looking statements. Such factors include, among others things, those risk factors set forth in this section and elsewhere in this report. We identify forward-looking statements by words such as may, will, should, could, expects, plans, anticipates, believes, estimates, predicts, potential, or continue or similar terms that refer to the future. We cannot guarantee future results, levels of activity, performance or achievements.

FACTORS THAT MAY AFFECT FUTURE OPERATING RESULTS

Investing in our common stock involves a high degree of risk. Any of the following risks could materially adversely affect our business, operating results and financial condition and could result in a complete loss of your investment.

In addition to the other information in this Report, the following factors should be considered carefully in evaluating the Company and its business. This disclosure is for the purpose of qualifying for the safe harbor provisions of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. It contains factors that could cause results to differ materially from such forward-looking statements. These factors are in addition to any other cautionary statements, written or oral, which may be made or referred to in connection with any such forward-looking statement.

The following matters, among other things, may have a material adverse effect on the business, financial condition, liquidity, or results of operations the Company. Reference to these factors in the context of a forward-looking statement or statements shall be deemed to be a statement that any one or more of the following factors may cause actual results to differ materially from those in such forward-looking statement or statements.

Before you invest in our common stock, you should be aware of various risks, including those described below. Investing in our common stock involves a high degree of risk. You should carefully consider these risk factors, together with all of the other information included in this Report, before you decide whether to purchase shares of our common stock. Our business and results of operations could be seriously harmed by any of the following risks. The trading price of our common stock could decline due to any of these risks, and you may lose part or all of your investment.

GENERAL RISKS

OUR BUSINESS FOCUS IS THE DEVELOPMENT AND ACQUISITION OF EARLY STAGE COMPANIES; HENCE, WE WILL ENCOUNTER NUMEROUS RISKS ASSOCIATED WITH OUR BUSINESS FOCUS AND OUR PRIOR OPERATING HISTORY MAY NOT BE A MEANINGFUL GUIDE TO EVALUATING OUR FUTURE PERFORMANCE.

At March 31, 2002 the Company held investments in four companies, Citadel, Parago, River Logic and Encore. Other than our formation and development of these companies, we have a brief history in executing our business strategy. As a consequence, our prior operating history may not provide a meaningful guide to our prospects in emerging markets. Moreover, our business model and prospects must be considered in light of the risk, expense and difficulties frequently encountered by companies in early stages of development, particularly companies in new and rapidly evolving markets. We may be unable to execute our strategy of developing our business due to numerous risks, including the following:

- We may be unable to identify or develop relationships with attractive emerging companies.
- Any companies that we are able to attract may not succeed and the value of our assets and the price of our common stock could consequently decline.

- Our business model is unproven and depends on the willingness of companies to participate in our business development model and collaborate with each other and us.
- Our expenses will increase as we build the infrastructure necessary to implement this model.
- We face competition from incubators, some of which are publicly traded companies, venture capital companies and large corporations; many of these competitors have greater financial resources and brand name recognition than we do, which may make it difficult for us to effectively compete.
- We will require additional capital resources in order to implement our business model and we may not be able to obtain these resources on attractive terms, if at all.

WE HAVE INVESTED IN EARLY STAGE VENTURES; AND THERE CAN BE NO ASSURANCE THAT OUR INVESTMENTS WILL PROVE TO BE FINANCIALLY ATTRACTIVE.

We have developed and invested in Citadel, Parago, River Logic and Encore (our "investees" or "investee companies"). Inasmuch as our investee companies are early stage ventures, it is difficult to judge their future prospects. Economic, governmental, industry and internal company factors outside of our control affect each of our investee companies. A significant portion of our assets is comprised of ownership interests in our investee companies. If our investee companies do not succeed, the value of our assets will decline.

CT HOLDINGS WILL NOT HAVE ACCESS TO THE CASH FLOW OR ASSETS OF CITADEL, AND MAY BE UNABLE TO OPERATE PROFITABLY FOLLOWING THE DISTRIBUTION

Historically, since the businesses that comprise each of Citadel and CT Holdings have been under one ultimate parent, they have been able to rely, to some degree, on the earnings, assets and cash flow of each other for capital requirements. After the Distribution, CT Holdings will not be able to rely on the security software business for such requirements. Following the Distribution, CT Holdings will continue to maintain its own credit and banking relationships and perform its own financial and investor relations functions. Because a significant number of key employees of CT Holdings will be employed by Citadel following the Distribution, there can be no assurance that CT Holdings will be able to successfully put in place the financial, administrative and managerial structure necessary to continue to operate as an independent public company, or that the development of such structure will not require a significant amount of management's time and other resources.

WE MAY INCUR SIGNIFICANT COSTS TO AVOID INVESTMENT COMPANY STATUS AND MAY SUFFER OTHER ADVERSE CONSEQUENCES IF WE ARE DEEMED TO BE AN INVESTMENT COMPANY.

We may incur significant costs to avoid investment company status and may suffer other adverse consequences if we are deemed to be an investment company under the Investment Company Act of 1940. Some of our contemplated equity investments in other businesses may constitute investment securities under the 1940 Act. A company may be deemed to be an investment company if it owns investment securities with a value exceeding 40% of its total assets, subject to certain exclusions. Investment companies are subject to registration under, and compliance with, the 1940 Act unless a particular exclusion or Securities and Exchange Commission safe harbor applies. If we were to be deemed an investment company, we would become subject to the requirements of the 1940 Act. As a consequence, we would be prohibited from engaging in some businesses or issuing our securities and might be subject to civil and criminal penalties for noncompliance. In addition, certain of our contracts might be voided, and a court-appointed receiver could take control of us and liquidate our business. Following the Distribution of Citadel, we may be deemed to be an investment company unless we qualify for a safe harbor within the time permitted under the 1940 Act.

Although we have yet to make any investments in the investment securities of companies other than Citadel, Parago, River Logic and Encore, such investments, if and when made, could fluctuate in value, which may cause the value of such securities to exceed 40% of our total assets. Unless an exclusion or safe harbor were available to us, we

would have to attempt to reduce our investment securities as a percentage of our total assets. This reduction could be accomplished in a number of ways, including the disposition of investment securities and the acquisition of non-investment security assets. If we were required to sell investment securities, we may sell them sooner than we may otherwise have preferred. These sales may be at depressed prices and we might never realize anticipated benefits from, and may incur losses on, these investments. Some investments may not be sold due to contractual or legal restrictions or the inability to locate a suitable buyer. Moreover, we may incur tax liabilities when we sell assets. We may also be unable to purchase additional investment securities that may be important to our operating strategy. If we decide to acquire non-investment security assets, we may not be able to identify and acquire suitable assets and businesses.

WE HAVE A HISTORY OF NET LOSSES AND WILL NEED ADDITIONAL FINANCING TO CONTINUE AS A GOING CONCERN.

We have incurred recurring operating losses and have a significant working capital deficiency and a significant stockholders' deficit. Cash used in continuing operations was approximately $289,000 during the quarter ended March 31, 2002. We have no cash balance at March 31, 2002 and current liabilities from continuing operations exceed current assets from continuing operations by approximately $2.1 million. We and our investee companies continue to be dependent upon external financing to perform our business development activities, invest in unconsolidated affiliates and provide for ongoing working capital requirements. During the quarter ended March 31, 2002 and the year ended December 31, 2001, substantially all of this financing has been provided by related parties.

Our strategy of continuing to support and expand our business development activities requires us to obtain additional capital. The complete implementation of this element of our strategy will not generate positive cash flow in the foreseeable future. Achieving positive cash flow is currently highly dependent upon obtaining liquidity from our investments in unconsolidated affiliates. We estimate we will need to raise additional funds to support the incubator and business development activities of the Company through the remainder of 2002 and substantially greater amounts if we expect to continue to acquire investments or if amounts become due to settle contingent liabilities. Historically, we have obtained short-term bridge funding from our Chief Executive Officer or Directors of the Company. While this may occur in the future there can be no assurance that such financing will be available, or if available on terms that we would be willing to accept.

We received a report from our independent auditors for its year ended December 31, 2001 containing an explanatory paragraph that describes the uncertainty regarding its ability to continue as a going concern due to historical negative cash flows and because, as of the date they rendered their opinion, we did not have access to sufficient committed capital to meet our projected operating needs for at least the next 12 months. Until we are able to create liquidity from our investments through a sale to a strategic investor, an initial public offering or some other liquidity transaction, we will continue to require working capital to fund our own operating expenses.

There can be no assurance that management's plans will be successful or what other actions may become necessary. Although we have been successful raising capital in the past, any inability to raise capital may require us to sell assets or reduce the level of our operations. In addition, we may suffer dilution of our equity ownership in our investee companies if they require additional financing and we elect not to participate in those additional financings. Such actions could have a material adverse effect on our business and operations and result in charges that could be material to our business and results of operations.

OUR STOCK IS TRADED IN THE OVER THE COUNTER MARKET.

Our common stock was de-listed from the Nasdaq SmallCap Market on May 17, 2001, because we did not meet the Nasdaq's requirements for continued listing. Our common stock now trades on the OTC Bulletin Board maintained by the National Quotation Bureau, Inc. The OTC Bulletin Board is generally considered to be a less efficient market, and our stock price, as well as the liquidity of our common stock, may be adversely impacted as a result.

WE ARE INVOLVED IN LEGAL PROCEEDINGS THAT COULD HAVE A MATERIAL ADVERSE EFFECT ON OUR BUSINESS

We are involved in legal proceedings as described in Part II, Item 1. Legal Proceedings and from time to time, we may be subject to other legal proceedings, including but not limited to claims that we have infringed the intellectual property rights of others, product liability claims, or other claims incidental to our business. While we intend to defend such lawsuits, adverse decisions or settlements, and the costs of defending such suits, could have a material adverse effect on our business.

OUR EARNINGS AND STOCK PRICE ARE SUBJECT TO SIGNIFICANT FLUCTUATIONS.

Due to the factors noted in this Report, our earnings and stock price have been and may continue to be subject to significant volatility, particularly on a quarterly basis. We have previously experienced shortfalls in revenue and earnings from levels expected by investors, which have had an immediate and significant adverse effect on the trading price of our common stock. This may occur again in the future.

RISKS RELATED TO CITADEL SECURITY SOFTWARE AND THE DISTRIBUTION

At March 31, 2002 Citadel Security Software is a wholly owned subsidiary of CT Holdings. Its balance sheet and results of operations are presented as discontinued operations in CT Holdings financial statements due to the pending spin-off of Citadel as a standalone public company. Because the spin-off had not happened as of March 31, 2002 management feels that the risk factors related to the Citadel should be presented herein to provide the reader a more complete disclosure of the business and incubator activities of CT Holdings, the risks associated with Citadel's business and the risks associated with the distribution.

CITADEL HAS A HISTORY OF NET LOSSES AND WILL NEED ADDITIONAL FINANCING TO CONTINUE AS A GOING CONCERN.

Citadel has incurred recurring operating losses and has a stockholders' deficit of approximately $1.2 million at March 31, 2002. It had cash provided by operations of approximately $12 thousand during the quarter ended March 31, 2002. At March 31, 2002 Citadel had a cash balance of approximately $12 thousand and current liabilities exceeded current assets by approximately $1.6 million. Citadel has and may continue to be dependent upon outside and related party financing to develop and market its software products, perform its business development and marketing activities and provide for ongoing working capital requirements. During the quarter ended March 31, 2002, substantially all of this financing was provided by related parties.

Citadel expects to generate cash from the sale of its software products and will incur costs relating to such product development, marketing and general corporate overhead that may result in a continuing cash deficiency. Achieving positive cash flow is currently highly dependent upon increasing sales of its products. Citadel estimates it will need to raise $3 million to $5 million of additional capital to fund its business plan through the remainder of 2002 and substantially greater funds if amounts become due to settle contingent liabilities. It may be required to seek additional funds from related parties, including its directors and officers. Historically, Citadel was funded by CT Holdings, which obtained its funding on a short-term bridge basis from its Chief Executive Officer and directors. While Citadel may seek similar funding in the future, there can be no assurance that such financing will be available, or if available, on terms that Citadel would be willing to accept.

Citadel received a report from its independent auditors for its year ended December 31, 2001 containing an explanatory paragraph that describes the uncertainty regarding its ability to continue as a going concern due to historical negative cash flows and because, as of the date they rendered their opinion, Citadel did not have access to sufficient committed capital to meet its projected operating needs for at least the next 12 months.

There can be no assurance that management's operating plans will be successful or what other actions may become necessary. Although Citadel has been successful raising capital in the past as part of CT Holdings, any inability to raise capital may require the company to reduce the level of its operations. Such actions could have a material adverse effect on its business operations and result in charges that could be material to its financial condition and results of operations.

FOLLOWING THE DISTRIBUTION CITADEL STOCKHOLDERS MAY EXPERIENCE SIGNIFICANT DILUTION IF FUTURE EQUITY OFFERINGS ARE USED TO FUND OPERATIONS, TO ACQUIRE COMPLEMENTARY BUSINESSES OR RESULTING FROM THE EXERCISE OF EMPLOYEE STOCK OPTIONS.

If future acquisitions are financed through the issuance of equity securities, Citadel stockholders could experience significant dilution. In addition, securities issued in connection with future financing activities or potential acquisitions may have rights and preferences senior to the rights and preferences of the Citadel Shares.

Citadel has granted options to purchase approximately 3,336,000 shares of Citadel common stock employees, including officers and directors, and Citadel may grant additional stock options in the future. The issuance of Citadel shares upon the exercise of these options may result in dilution to the Citadel stockholders.

CITADEL HAS NO OPERATING HISTORY AS AN INDEPENDENT PUBLIC COMPANY AND MAY BE UNABLE TO OPERATE PROFITABLY AS A STAND-ALONE COMPANY

Although CT Holdings and its predecessors have operated as a reporting public company since 1994 and have sold security software since 1992, Citadel does not have an operating history as an independent public company. Historically, since the businesses that comprise each of Citadel and CT Holdings have been under one ultimate parent, they have been able to rely, to some degree, on the earnings, assets and cash flow of each other for capital requirements. After the Distribution, Citadel will be able to rely only on the security software business for such requirements. The security software business has operated at a loss in the past for CT Holdings, and there can be no assurance that, as an independent company, such losses will not continue or increase. Additionally, Citadel's business has relied on CT Holdings for financial, administrative and managerial expertise in conducting its operations. Following the Distribution, CT Holdings will continue to maintain its own credit and banking relationships and perform its own financial and investor relations functions. While a significant number of key employees of CT Holdings will be employed by Citadel following the Distribution, there can be no assurance that Citadel will be able to successfully put in place the financial, administrative and managerial structure necessary to operate as an independent public company, or that the development of such structure will not require a significant amount of management's time and other resources.

CITADEL'S HISTORICAL FINANCIAL INFORMATION MAY BE OF LIMITED RELEVANCE

The financial statements of Citadel include the accounts of the security software business of CT Holdings and have been prepared on an historical cost basis in accordance with accounting principles generally accepted in the United States and present Citadel's financial position, results of operations, and cash flows as derived from CT Holdings' historical financial statements. CT Holdings assets, liabilities and expenses relating to the security software business have been allocated to Citadel based on specific identification or where specific identification was not readily available Citadel used an estimate of the proportion of corporate amounts allocable to Citadel, based on such factors as revenues, number of employees, and other relevant factors deemed appropriate for the allocation. In the opinion of Citadel's management, the allocations have been made on a reasonable basis and Citadel believes that all amounts allocated to Citadel are a reasonable representation of the assets, liabilities, revenues, costs and expenses that would have been recorded if Citadel had performed these functions as a stand-alone company.

The historical financial information included in Citadel's separate financial statements represents an estimate of the results of operations, financial position and cash flows of Citadel had it operated as a separate stand-alone entity during the periods presented and does not, and may not, be representative of Citadel's future results of operations, financial position and cash flows. The financial information included herein does not reflect any changes that may occur in the funding and operations of Citadel as a result of the Distribution.

CITADEL EARNINGS AND STOCK PRICE ARE SUBJECT TO SIGNIFICANT FLUCTUATIONS.

The historical earnings and stock price of CT Holdings of which Citadel has been a wholly owned subsidiary, have been subject to significant volatility, particularly on a quarterly basis. The security software business as part of CT Holdings has experienced shortfalls in revenue and earnings from levels expected by investors, which have had an immediate and significant adverse effect on the trading price of its common stock. As a stand-alone company this may occur in the future and have a significant adverse impact on the stock price of Citadel following the Distribution.

IF CITADEL LOSES THE SERVICES OF ANY OF ITS KEY PERSONNEL, INCLUDING THE CHIEF EXECUTIVE OFFICER OR DIRECTORS, ITS BUSINESS MAY SUFFER.

Citadel is dependent on its key officers, including Steven B. Solomon, its Chairman and Chief Executive Officer, directors, and key employees in finance, technology, sales and marketing. Citadel's business could be negatively impacted if Citadel were to lose the services of one or more of these persons.

MEMBERS OF CITADEL'S BOARD OF DIRECTORS AND MANAGEMENT MAY HAVE CONFLICTS OF INTEREST AFTER THE DISTRIBUTION

Members of the board of directors and management of Citadel will own shares of both Citadel and CT Holdings common stock after the Distribution because of their prior relationship and, in some cases, continuing relationships as directors or executive officers with CT Holdings. In addition, two of the five initial directors of Citadel will also be directors of CT Holdings, and the Chief Executive Officer and Chief Financial Officer of Citadel will also continue to serve as Chief Executive Officer and Chief Financial Officer of CT Holdings. These relationships could create, or appear to create, potential conflicts of interest when Citadel's directors and management are faced with decisions that could have different implications for Citadel and CT Holdings. Examples of these types of decisions might include the resolution of disputes arising out of the agreements governing the relationship between CT Holdings and Citadel following the Distribution. Also, the appearance of conflicts, even if such conflicts do not materialize, might adversely affect the public's perception of Citadel following the Distribution.

THE SOFTWARE INDUSTRY IS CHARACTERIZED BY RAPID TECHNOLOGICAL CHANGE AND CITADEL WILL NEED TOADAPT ITS DEVELOPMENT TO THESE CHANGES.

Citadel participates in a highly dynamic industry characterized by rapid change and uncertainty relating to new and emerging technologies and markets. Future technology or market changes may cause some of its products to become obsolete more quickly than expected.

INTRODUCTION OF NEW OPERATING SYSTEMS MAY CAUSE SIGNIFICANT FLUCTUATIONS IN CITADEL'S FINANCIAL RESULTS AND STOCK PRICE.

If Citadel is unable to successfully and timely develop products that operate under existing or new operating systems, or if pending or actual releases of the new operating systems delay the purchase of Citadel's products, future revenues and operating results could be materially adversely affected. Additionally, as hardware vendors incorporate additional server-based network management and security tools into network operating systems, the demand may decrease for some of Citadel's products, including those currently under development.

THE TREND TOWARD CONSOLIDATION IN THE SOFTWARE INDUSTRY MAY IMPEDE CITADEL'S ABILITY TO COMPETE EFFECTIVELY.

As consolidation in the software industry continues, fewer companies dominate particular markets, changing the nature of the market and potentially providing consumers with fewer choices. Also, many of these companies offer a broader range of products than Citadel, ranging from desktop to enterprise solutions. Citadel may not be able to compete effectively against these competitors. Furthermore, Citadel may use strategic acquisitions, as necessary, to acquire technology, people and products to execute its overall product strategy. As part of CT Holdings, Citadel completed a number of acquisitions and dispositions of technologies, companies and products and may acquire and dispose of other technologies, companies and products in the future. The trend toward consolidation in the software

industry may result in increased competition in acquiring these technologies, people or products, resulting in increased acquisition costs or the inability to acquire the desired technologies, people or products. Any of these changes may have a significant adverse effect on Citadel's future revenues and operating results.

CITADEL FACES INTENSE PRICE-BASED COMPETITION FOR LICENSING OF ITS PRODUCTS.

Price competition is often intense in the software market, especially for security software products. Many of Citadel's competitors have significantly reduced the price of their products. Price competition may continue to increase and become even more significant in the future, resulting in reduced profit margins.

CITADEL MUST EFFECTIVELY ADAPT TO CHANGES IN THE DYNAMIC TECHNOLOGICAL ENVIRONMENT OF THE INTERNET IN A TIMELY MANNER.

Critical issues concerning the commercial use of the Internet, including security, reliability, cost, ease of use, accessibility, quality of service or potential tax or other government regulation, remain unresolved and may affect the use of the Internet as a medium to distribute or support Citadel's software products and the functionality of some of its products. If Citadel is unsuccessful in timely assimilating changes in the Internet environment into its business operations and product development efforts, its future net revenues and operating results could be adversely affected.

CITADEL MAY BE UNSUCCESSFUL IN UTILIZING NEW DISTRIBUTION CHANNELS.

Citadel currently licenses its products over the Internet and through direct marketing, among other channels. It may not be able to effectively adapt its existing, or adopt new, methods of distributing its software products utilizing the rapidly evolving Internet and related technologies. The adoption of new channels may adversely impact existing channels and/or product pricing, which may reduce future revenues and profitability.

THE INCREASED USE OF SITE LICENSES AND VOLUME LICENSING AGREEMENTS MAY INCREASE FLUCTUATIONS IN FINANCIAL RESULTS AND COULD AFFECT CITADEL'S BUSINESS.

Citadel's typical licensing pattern involves the licensing of a small number of licenses with high margins, a short sales cycle and without deployment of significant resources. Often times a licensee downloads software products from Citadel's website and pays the license fee with a credit card. Citadel is now beginning to emphasize corporate site licenses and volume licensing agreements to corporations and small and mid sized businesses. A corporate site license typically allows a customer to use Citadel's software products across his entire business or an entire site within his business. A volume license agreement typically provides the customer with a large number of licenses at a significantly reduced price. These licensing arrangements tend to result in larger revenue per customer but also involve a longer sales cycle, require greater investment of resources in establishing the enterprise relationship and can sometimes result in lower operating margins. The timing of the execution of these licenses and the associated renewal of support services, or their non-renewal or renegotiation by the customers, could cause Citadel's results of operations to vary significantly from quarter to quarter. In addition, if the corporate marketplace grows and becomes a larger component of the overall market opportunity, Citadel may not be successful in expanding its corporate segment to take advantage of this growth.

THE RESULTS OF RESEARCH AND DEVELOPMENT EFFORTS ARE UNCERTAIN.

Citadel believes that it will need to continue to make significant research and development expenditures to remain competitive. While Citadel performs extensive usability and beta testing of new products, the products currently under development or may develop in the future may not be technologically successful. If they are not technologically successful, the resulting products may not achieve market acceptance and may not compete effectively with products of competitors currently in the market or introduced in the future.

THE LENGTH OF THE PRODUCT DEVELOPMENT CYCLE IS DIFFICULT TO PREDICT.

The length of the product development cycle has generally been greater than originally expected. Therefore Citadel is likely to experience delays in future product development. These delays could have a material adverse affect on the amount and timing of future revenues.

CITADEL MUST MANAGE AND RESTRUCTURE ITS OPERATIONS EFFECTIVELY

Citadel continually evaluates its product and corporate strategy. Citadel has in the past undertaken and will in the future undertake organizational changes and/or product and marketing strategy modifications as business conditions make necessary from time-to-time. These organizational changes increase the risk that objectives will not be met due to the allocation of valuable limited resources to implement changes. Further, due to the uncertain nature of any of these undertakings, these efforts may not be successful and Citadel may not realize any benefit from these efforts.

CITADEL MUST ATTRACT AND RETAIN PERSONNEL WHILE COMPETITION FOR PERSONNEL IN ITS INDUSTRY IS INTENSE.

Citadel believes that its future success will depend in part on its ability to recruit and retain highly skilled management, sales, marketing and technical personnel. Competition in recruiting personnel in the software industry is intense. Citadel may not be successful in attracting and retaining qualified personnel. The loss of the services of any key personnel or Citadel's inability to hire new personnel with the requisite skills could restrict its ability to develop new products or enhance existing products in a timely manner, license products to its customers or manage its business effectively. To continue to attract ad retain qualified employees, Citadel believes that it must provide personnel with a competitive compensation package, including stock options. Citadel may not be able to hire or retain qualified personnel if unable to offer competitive salaries and benefits, or if the Citadel stock does not perform well. In addition, as a stand-alone company Citadel may find it more difficult to attract personnel. Citadel may have to increase salaries and benefits which would increase its expenses and reduce profitability or increase losses.

CITADEL'S SOFTWARE PRODUCTS MAY BE SUBJECT TO DEFECTS AND PRODUCT LIABILITY.

Software products frequently contain errors or defects, especially when first introduced or when new versions or enhancements are released. Citadel tests its products prior to release and has not experienced any material adverse effects resulting from any of these defects or errors to date. Nonetheless, defects and errors could be found in current versions of its products, future upgrades to current products or newly developed and released products. Software defects could result in delays in market acceptance or unexpected reprogramming costs, which could materially adversely affect Citadel's operating results. Most of its license agreements with customers contain provisions designed to limit exposure to potential product liability claims. It is possible, however, that these provisions limiting liability may not be valid under federal, state, local or foreign laws or ordinances or as a result of unfavorable judicial decisions. A successful product liability claim could have a material adverse affect on Citadel's business, operating results and financial condition.

CITADEL'S SOFTWARE PRODUCTS AND WEBSITE MAY BE SUBJECT TO INTENTIONAL DISRUPTION.

While Citadel has not been the target of software viruses or other attacks specifically designed to impede the performance of its products or disrupt its website, such viruses or other attacks could be created and deployed against its products or website in the future. Similarly, experienced computer programmers, or hackers, may attempt to penetrate its network security or the security of its website from time to time. A hacker who penetrates Citadel's network or website could misappropriate proprietary information or cause interruptions of its services. Citadel might be required to expend significant capital and resources to protect against, or to alleviate, problems caused by virus creators and hackers.

CITADEL RELIES ON THIRD PARTY TECHNOLOGIES.

Citadel's software products are designed to run on multiple operating systems and integrate with security products from other vendors. Although Citadel believes that the target operating systems and products are and will be widely utilized by businesses in the corporate market, no assurances can be given that these businesses will actually adopt such technologies as anticipated or will not in the future migrate to other computing technologies that Citadel does not support. Moreover, if its products and technology are not compatible with new developments from these companies, as to which there can be no assurances, its business, results of operations and financial condition could be materially and adversely affected.

CITADEL RELIES ON OUTSIDE RESEARCH ORGANIZATIONS.

With respect to security vulnerability research, Citadel has contracted with Security Focus to provide updated vulnerability research data in addition to its own research efforts. Citadel's research team uses publicly available sources to find information on known and new vulnerabilities and their attributes. There can be no assurance that Security Focus or the publicly available sources will continue to operate as a going concern and that the data they provide will be delivered without interruption.

CITADEL FACES AGGRESSIVE COMPETITION IN MANY AREAS OF ITS BUSINESS, AND WILL BE HARMED IF IT FAILS TO COMPETE EFFECTIVELY.

Citadel encounters aggressive competition from numerous competitors in many areas of its business. Many of its current and potential competitors have longer operating histories, greater name recognition and substantially greater financial, technical and marketing resources than Citadel and accordingly it may not be able to compete effectively with these competitors. To remain competitive, Citadel must develop new products and periodically enhance its existing products in a timely manner. Citadel anticipates that it may have to adjust the prices of many of its products to stay competitive. In addition, new competitors may emerge, and entire product lines may be threatened by new technologies or market trends that reduce the value of these product lines.

The market in which Citadel competes is influenced by the strategic direction of major computer hardware manufacturers and operating system software providers. Citadel's competitiveness depends on its ability to enhance existing products and to introduce successful new products on a timely basis. Citadel has limited resources and must restrict product development efforts to a relatively small number of projects.

CITADEL'S QUARTERLY FINANCIAL RESULTS ARE SUBJECT TO SIGNIFICANT FLUCTUATIONS, WHICH COULD CAUSE ITS STOCK PRICE TO DECREASE.

Citadel has been subject to substantial fluctuations in quarterly net revenues and operating results, and these fluctuations may occur in the future. Fluctuations may be caused by a number of factors, including:

- the timing and volume of customer orders, customer cancellations, and reductions in orders by distributors;
- the timing and amount of expenses;
- the introduction of competitive products by existing or new competitors;
- reduced demand for any given product;
- seasonality in the end-of-period buying patterns of foreign and domestic software markets; and
- the market's transition between operating systems.

Due to these factors, forecasts may not be achieved, either because expected revenues do not occur or because they occur at lower prices or on terms that are less favorable to us. In addition, these factors increase the chances that Citadel's results could diverge from the expectations of investors and analysts. If so, the market price of Citadel's stock would likely decrease.

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CITADEL'S MANAGEMENT TEAM IS NEW.

Citadel has only recently assembled its management team, as part of the distribution and changes in its operating structure. While some members of the management team have worked with each other in the past, Citadel cannot assess at this time the effectiveness of their working relationships after the Distribution.

CITADEL RELIES ON INTELLECTUAL PROPERTY AND PROPRIETARY RIGHTS.

Citadel regards its software and the underlying technology as proprietary. Citadel seeks to protect its proprietary rights through a combination of confidentiality agreements, licenses and copyright, patent, trademark and trade secret laws. However, Citadel does not employ technology to prevent copying of its products. Third parties may copy aspects of products or otherwise obtain and use Citadel's proprietary information without authorization or develop similar technology independently.

Citadel does not have any patents or statutory copyrights on any of its proprietary technology that it believes to be material to its future success. Although Citadel has filed a provisional patent application with respect to some of its business applications and intellectual property rights related to its Hercules software, Citadel has not been issued any patents and cannot assure you that any will be issued from its provisional patent application. Future patents, if any, may be successfully challenged and may not provide Citadel with any competitive advantages. Citadel may not develop proprietary products or technologies that are patentable and other parties may have prior claims.

In selling its products, Citadel relies primarily on shrink-wrap licenses that are not signed by licensees, and, therefore, such licenses may be unenforceable under the laws in some jurisdictions. In addition, existing copyright laws afford limited practical protection. Furthermore, the laws of some foreign countries do not offer the same level of protection of proprietary rights as the laws of the United States.

Patent, trademark and trade secret protection is important to Citadel because developing and marketing new technologies and products is time-consuming and expensive. Citadel does not own any U.S. or foreign patents or registered intellectual property. Citadel may not be able to obtain access to issued patents or other protection from any future patent applications owned by or licensed to Citadel.

Citadel's competitive position is also dependent upon unpatented trade secrets. Trade secrets are difficult to protect. Citadel's competitors may independently develop proprietary information and techniques that are substantially equivalent to Citadel's or otherwise gain access to its trade secrets, such as through unauthorized or inadvertent disclosure of Citadel trade secrets.

There can be no assurance that Citadel's means of protecting its proprietary rights will be adequate or that its competitors will not independently develop similar technology substantially equivalent or superseding proprietary technology. Furthermore, there can be no assurance that any confidentiality agreements between Citadel employees and the Company will provide meaningful protection of its proprietary information, in the event of any unauthorized use or disclosure thereof. Any legal action that Citadel may bring to protect proprietary information could be expensive and may distract management from day-to-day operations.

CITADEL IS INVOLVED IN LITIGATION, AND MAY BECOME INVOLVED IN FUTURE LITIGATION, WHICH MAY RESULT IN SUBSTANTIAL EXPENSE AND MAY DIVERT ATTENTION FROM THE IMPLEMENTATION OF ITS BUSINESS STRATEGY.

Citadel believes that the success of its business strategy depends, in part, on obtaining intellectual property protection for its products, defending its intellectual property once obtained and preserving its trade secrets. Litigation may be necessary to enforce its intellectual property rights, to protect its trade secrets and to determine the validity and scope of its proprietary rights. Any litigation could result in substantial expense and diversion of management attention from the business strategy, and may not adequately protect Citadel's intellectual property rights.

In addition, Citadel may be sued by third parties who claim that Citadel's products infringe on the intellectual property rights of others. This risk is exacerbated by the fact that the validity and breadth of claims covered in technology patents involve complex legal and factual questions for which important legal principles are unresolved. Any litigation or claims against Citadel, whether or not valid, could result in substantial costs, place a significant strain on its financial resources, divert management resources and harm Citadel's reputation. Such claims could result in awards of substantial damages, which could have a significant adverse impact on Citadel's results of operations. In addition, intellectual property litigation or claims could force Citadel to:

- cease licensing, incorporating or using any of its products that incorporate the challenged intellectual property, which would adversely affect revenue;

- obtain a license from the holder of the infringed intellectual property right, which license may not be available on reasonable terms, if at all; and

- redesign its products, which would be costly and time-consuming.

As part of the Distribution, CT Holdings has assigned to Citadel a legal proceeding in which CT Holdings is a defendant. From time to time, Citadel may be subject to legal claims incidental to its business. Citadel may suffer an unfavorable outcome as a result of one or more these claims. Citadel does not expect the final resolution of these claims to have a material adverse effect on its financial position, individually or in the aggregate. However, depending on the amount and timing of unfavorable resolutions of claims against Citadel, or the costs of settlement or litigation, its future results of operations or cash flows could be materially adversely affected.

CT Holdings is a party to some legal proceedings, to which Citadel is not a party. If a court in a lawsuit by an unpaid creditor or representative of creditors, such as a trustee in bankruptcy, were to find that at the time CT Holdings effected the Distribution, CT Holdings or Citadel (1) was insolvent; (2) was rendered insolvent by reason of the Distribution; (3) was engaged in a business or transaction for which their respective remaining assets constituted unreasonably small capital; or (4) intended to incur, or believed it would incur, debts beyond its ability to pay as such debts matured, such court may be asked to void the Distribution (in whole or in part) as a fraudulent conveyance and require that the stockholders return the Citadel Shares (in whole or in part) to CT Holdings or require Citadel to fund certain liabilities for the benefit of creditors. The measure of insolvency for purposes of the foregoing will vary depending upon the jurisdiction whose law is being applied. Generally, however, CT Holdings or Citadel would be considered insolvent if the fair value of their respective assets were less than the amount of their respective liabilities or if they incurred debt beyond their ability to repay such debt as it matures.

CITADEL MAY INCUR INCREASED EXPENSES IF THE TRANSITION SERVICES AGREEMENT WITH CT HOLDINGS IS TERMINATED

In connection with the Distribution, Citadel will enter into a transition services agreement with CT Holdings. This agreement will provide that CT Holdings and Citadel will provide each other services for a fee in such areas as information management and technology, employee benefits administration, payroll, financial accounting and reporting, claims administration and reporting, and other areas where CT Holdings and Citadel may need transitional assistance and support following the Distribution. The agreement will generally extend for one year after the Distribution, but may be terminated earlier under certain circumstances, including a default. If the agreement is terminated, Citadel may be required to obtain such services from a third party or increase its headcount to provide such services. This could be more expensive than the fees which Citadel will be required to pay under the transition services agreement.

SOME PROVISIONS OF CITADEL'S CERTIFICATE OF INCORPORATION, BYLAWS AND THE TAX DISAFFILIATION AGREEMENT MAY DISCOURAGE TAKEOVERS

Citadel's certificate of incorporation and bylaws contain some anti-takeover provisions that may make more difficult or expensive or that may discourage a tender offer, change in control or takeover attempt that is opposed by Citadel's board of directors. In particular, Citadel's certificate of incorporation and bylaws:

(1) classify Citadel's board of directors into three groups, so that stockholders elect only one-third of the board each year;

(2) permit stockholders to remove directors only for cause and only by the affirmative vote of at least 80% of Citadel's voting shares;

(3) permit a special stockholders' meeting to be called only by a majority of the board of directors;

(4) do not permit stockholders to take action except at an annual or special meeting of stockholders;

(5) require stockholders to give Citadel advance notice to nominate candidates for election to Citadel's board of directors or to make stockholder proposals at a stockholders' meeting;

(6) permit Citadel's board of directors to issue, without stockholder approval, preferred stock with such terms as the board may determine;

(7) require the vote of the holders of at least 80% of Citadel's voting shares for stockholder amendments to Citadel's bylaws; and

(8) require, for the approval of a business combination with stockholders owning 5% or more of Citadel's voting shares, the vote of at least 50% of Citadel's voting shares not owned by such stockholder, unless certain fair price requirements are met or the business combination is approved by the continuing directors of Citadel.

These provisions of Citadel's certificate of incorporation and bylaws, and Delaware law could discourage potential acquisition proposals and could delay or prevent a change in control of Citadel, even though a majority of Citadel's stockholders may consider such proposals, if effected, desirable. These provisions could also make it more difficult for third parties to remove and replace the members of Citadel's board of directors. Moreover, these provisions could diminish the opportunities for stockholders to participate in some tender offers, including tender offers at prices above the then-current market value of the Citadel Shares, and may also inhibit increases in the trading price of the Citadel Shares that could result from takeover attempts or speculation.

In connection with the Distribution, Citadel has agreed to indemnify CT Holdings for all taxes and liabilities incurred as a result of Citadel's or an affiliate's post-Distribution action or omission contributing to an Internal Revenue Service determination that the Distribution was not tax-free. Unless CT Holdings effectively rebuts the presumption that a change in control transaction involving Citadel or disposition of Citadel occurring within the four-year period beginning two years prior to the Distribution Date is pursuant to the same plan or series of related transactions as the Distribution, the Internal Revenue Service might determine that the Distribution was not tax-free, giving rise to Citadel's indemnification obligation. These provisions of the tax disaffiliation agreement may have the effect of discouraging or preventing an acquisition of Citadel or a disposition of Citadel's businesses, which may in turn depress the market price for the Citadel Shares.

MANAGEMENT BELIEVES THAT THE DISTRIBUTION HAS CAUSED THE TRADING PRICE OF CT HOLDINGS COMMON STOCK TO DECLINE

Following the Distribution, CT Holdings expects that its common stock will continue to be listed and traded on the Over The Counter Bulletin Board under the symbol CITN. There can be no assurance that a trading market will continue for the shares of CT Holdings common stock or develop for the Citadel shares. Management believes that as a result of the Distribution, the trading price of CT Holdings common stock immediately following the ex-dividend date for the Distribution was substantially lower than the trading price of CT Holdings common stock immediately prior to Distribution. Following the Distribution, CT Holdings' operations will consist of the equity interests in its incubation holdings, Parago, River Logic and Encore, and CT Holdings' related business development operations, including potential future acquisitions. Further, the combined trading prices of CT Holdings common stock and the Citadel Shares after the Distribution may be less than the trading price of CT Holdings common stock

immediately prior to the Distribution.

SUBSTANTIAL SALES OF CT HOLDINGS COMMON STOCK MAY HAVE AN ADVERSE IMPACT ON THE TRADING PRICE OF THE CT HOLDINGS COMMON STOCK

After the Distribution, some CT Holdings stockholders may decide that they do not want shares in a company consisting of the incubation ventures and related business development operations, and may sell their CT Holdings common stock following the Distribution. If CT Holdings stockholders sell large numbers of shares of CT Holdings common stock over a short period of time, or if investors anticipate large sales of CT Holdings common stock over a short period of time, this could adversely affect the trading price of the CT Holdings common stock.

SUBSTANTIAL SALES OF CITADEL SHARES MAY HAVE AN ADVERSE IMPACT ON THE TRADING PRICE OF THE CITADEL SHARES

Based on the number of shares of CT Holdings common stock anticipated to be outstanding on the Record Date CT Holdings will distribute to CT Holdings' stockholders a total of approximately 15,000,000 Citadel Shares. Under the United States federal securities laws, substantially all of these shares may be resold immediately in the public market, except for (1) Citadel Shares held by affiliates of Citadel or (2) shares which are issued in respect of restricted shares of CT Holdings common stock. Some of the CT Holdings stockholders who receive Citadel Shares may decide that they do not want shares in a company consisting of the security software business, and may sell their Citadel Shares following the Distribution. Citadel cannot predict whether stockholders will resell large numbers of Citadel Shares in the public market following the Distribution or how quickly they may resell these Citadel Shares. If Citadel stockholders sell large numbers of Citadel Shares over a short period of time, or if investors anticipate large sales of Citadel Shares over a short period of time, this could adversely affect the trading price of the Citadel Shares.

THERE CAN BE NO ASSURANCE THAT AN ACTIVE TRADING MARKET FOR CT HOLDINGS COMMON STOCK WILL RETURN

Even though CT Holdings is currently a publicly held company, there can be no assurance as to whether an active trading market for CT Holdings common stock will be maintained after the Distribution or as to the prices at which the CT Holdings common stock will trade. Some CT Holdings stockholders may decide that they do not want shares in a company consisting of the incubation ventures and related business development operations, and may sell their CT Holdings common stock following the Distribution. These and other factors may delay or hinder the return to an orderly trading market in the CT Holdings common stock following the Distribution. Whether an active trading market for CT Holdings common stock will be maintained after the Distribution and the prices for CT Holdings common stock will be determined in the marketplace and may be influenced by many factors, including the depth and liquidity of the market for the shares, CT Holdings' results of operations, what investors think of CT Holdings and the incubation ventures and business development industries, changes in economic conditions in its industries and general economic and market conditions. Market fluctuations could have a material adverse impact on the trading price of the CT Holdings common stock.

THERE HAS NOT BEEN ANY PRIOR TRADING MARKET FOR THE CITADEL SHARES AND THERE CAN BE NO ASSURANCE THAT ONE WILL DEVELOP

There is no current trading market for the Citadel Shares, although a when-issued trading market may develop prior to completion of the Distribution. The Citadel Shares will be listed on the Over The Counter Bulletin Board under a symbol to be assigned by the OTCBB prior to commencement of trading. There can be no assurance as to whether the Citadel Shares will be actively traded or as to the prices at which the Citadel Shares will trade. Some of the CT Holdings stockholders who receive Citadel Shares may decide that they do not want shares in a company consisting of a security software business, and may sell their Citadel Shares following the Distribution. This may delay the development of an orderly trading market in the Citadel Shares for a period of time following the Distribution. Until the Citadel Shares are fully distributed and an orderly market develops, the prices at which the Citadel Shares trade may fluctuate significantly and may be lower than the price that would be expected for a fully distributed issue.

Prices for Citadel Shares will be determined in the marketplace and may be influenced by many factors, including the depth and liquidity of the market for the shares, Citadel's results of operations, what investors think of Citadel and the security software industry, changes in economic conditions in the security software industry, and general economic and market conditions. Market fluctuations could have a material adverse impact on the trading price of the Citadel Shares.

FAILURE TO QUALIFY AS A TAX-FREE TRANSACTION COULD RESULT IN SUBSTANTIAL

LIABILITY

CT Holdings and Citadel intend for the Distribution to be tax-free for U.S. federal income tax purposes. Neither CT Holdings nor Citadel has requested an advance ruling from the Internal Revenue Service, or any opinion of their tax advisors, as to the tax consequences of the Distribution. No assurance can be given that the Internal Revenue Service or the courts will agree that the Distribution is tax-free.

If the Distribution does not qualify for tax-free treatment, a substantial corporate tax would be payable by the consolidated group of which CT Holdings is the common parent measured by the difference between (1) the aggregate fair market value of the Citadel Shares on the Distribution Date and (2) CT Holdings' adjusted tax basis in the Citadel Shares on the Distribution Date. The corporate level tax would be payable by CT Holdings. However, Citadel has agreed under certain circumstances to indemnify CT Holdings for all or a portion of this tax liability. This indemnification obligation, if triggered, could have a material adverse effect on the results of operations and financial position of Citadel. In addition, under the applicable treasury regulations, each member of CT Holdings' consolidated group (including Citadel) is severally liable for such tax liability.

Furthermore, if the Distribution does not qualify as tax-free, each CT Holdings stockholder who receives Citadel Shares in the Distribution would be taxed as if he had received a cash dividend equal to the fair market value of his Citadel Shares on the Distribution Date.

Even if the Distribution qualifies as tax-free, CT Holdings could nevertheless incur a substantial corporate tax liability under Section 355(e) of the Internal Revenue Code of 1986, as amended (the Internal Revenue Code or the Code), if CT Holdings or Citadel were to undergo a change in control (whether by acquisition, additional share issuance or otherwise) pursuant to a plan or series of related transactions which include the Distribution. Any transaction which occurs within the four-year period beginning two years prior to the Distribution is presumed to be part of a plan or series of related transactions which includes the Distribution unless CT Holdings establishes otherwise. Under certain circumstances, Citadel would be obligated to indemnify CT Holdings for all or a portion of this substantial corporate tax liability under the tax disaffiliation agreement. This indemnification obligation would have a material adverse effect on the results of operations and financial position of Citadel.

RISKS RELATED TO OUR INVESTEES

The following are some risks related to the business of Parago, River Logic and Encore, our investees, and should be considered in addition to the risk factors described in this Report. Any of these factors could have a material adverse effect on us.

THERE CAN BE NO ASSURANCE THAT OUR INVESTEES WILL COMPLETE AN INITIAL PUBLIC OFFERING OR OTHER LIQUIDITY EVENT.

There can be no assurance that any of our investees will complete an initial public offering or other liquidity event. The failure to complete an offering or other liquidity event such as an acquisition by a third party could have a material adverse effect on our stock price. You cannot be assured that an initial public offering or other liquidity event will occur in the near future or ever at all. In addition, we have agreed to convert the shares of Parago common stock issued in connection with the acquisition of 2-Lane Media by Parago into up to 500,000 of our shares at the option of the 2-Lane Media shareholders. Shareholders owning 1,200 of these shares of Parago stock exercised their option to obtain 139,806 shares of CT common stock. Pursuant to the terms of the subscription agreements between Parago and some of its stockholders, we may be required to issue up to 414,000 shares of our common stock based

on a conversion price of $3.75 per share (above the fair market value on the dates of issuance) at the option of such stockholders. Shareholders owning 40 of these shares of Parago stock exercised their option to obtain 16,000 shares of CT common stock. These provisions could have the effect of diluting our stockholders if the market price for our stock is above that price at the time of conversion.

WE MAY NOT BE ABLE TO EFFECT THE DISTRIBUTION OF PARAGO SHARES.

We previously announced that we intend to distribute shares of Parago common stock to our shareholders upon compliance with the Securities and Exchange Commission (SEC) requirements applicable in connection with the proposed distribution and upon the expiration of a 180 day lockup agreement between the underwriters of Parago's previously proposed initial public offering and us. If there are problems associated with compliance with SEC requirements or state law, then the distribution of Parago shares may be delayed or may not occur. As noted above, there can be no assurance that Parago will complete an IPO. There can be no assurance that we will complete the distribution on the proposed terms or at all.

OUR INVESTEES' BUSINESSES AND FUTURE PROSPECTS ARE EXTREMELY DIFFICULT TO EVALUATE BECAUSE THEIR OPERATING HISTORIES ARE VERY LIMITED AND THEIR BUSINESS MODELS ARE NEW, UNPROVEN AND EVOLVING.

Our investees were formed recently, therefore each investee has only a limited operating history on which one can base an investment decision. You should consider their prospects in light of the uncertainties and difficulties frequently encountered by companies in their early stages of development.

In addition, each investee's business model is new, unproven and evolving. We cannot assure that our investees' business models will be commercially successful, or that their solutions will be accepted by businesses or consumers. If our investees are unable to establish pricing and service models acceptable to manufacturers, retailers and service providers and attractive to their customers, their solutions may not be commercially successful.

EACH INVESTEE HAS A HISTORY OF NET LOSSES AND EXPECTS TO CONTINUE TO INCUR SUBSTANTIAL NET LOSSES IN THE FUTURE.

Each investee had a unaudited net losses for the year ended December 31, 2001 and we anticipate that each investee will incur additional losses for the foreseeable future. If our investees' revenues do not grow as they anticipate, our investees may never be profitable.

TO CONTINUE THEIR OPERATIONS AND BUSINESSES, OUR INVESTEES MUST RAISE ADDITIONAL FINANCING.

Our investees' ability to maintain and grow their businesses is dependent on access to sufficient funds to support their working capital and capital expenditure needs. If our investees do not raise additional funds, their businesses and results of operations will be seriously harmed, and our assets and share price would be materially and adversely impacted. This additional financing may not be available to our investees on a timely basis if at all, or, if available, on terms acceptable to our investees. Moreover, additional financing may cause material and immediate dilution to existing stockholders of our investees, including us.

IN THE EVENT OF THE COMPLETION OF AN INITIAL PUBLIC OFFERING BY ANY OF OUR INVESTEES, THEIR STOCK PRICE IS LIKELY TO BE VERY VOLATILE.

Currently, the securities of our investees cannot be bought or sold publicly. There can be no assurance that any of our investees will be able to complete an initial public offering. Although it is anticipated that the initial public offering price (if an initial public offering is completed) would be determined based on several factors, the market price after the offering may vary significantly from the initial offering price. The market price of our investees'

common stock is likely to be highly volatile and could be subject to wide fluctuations in response to factors that are beyond its control. A decline in their stock price will adversely affect our stock price.

Domestic and international stock markets often experience extreme price and volume fluctuations. Market fluctuations, as well as general political and economic conditions, such as a recession or interest rate or currency rate fluctuations, could adversely affect the market price of Parago's common stock, if it becomes publicly traded.

Sales of a substantial number of shares of our investees' common stock in the public market after its initial public offering could depress the market price of their common stock and could impair their ability to raise capital through the sale of additional equity securities.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

You should read the following discussion in conjunction with our audited financial statements for the year ended December 31, 2001 and the ten month period ended December 31, 2000 and the related notes in the Company's Form 10-KSB. Our year ends on December 31, and each of our quarters end on the final day of a calendar quarter (each March 31, June 30 and September 30). The following discussion contains forward-looking statements. Please see Forward-Looking Statements for a discussion of uncertainties, risks and assumptions associated with these statements.

OVERVIEW

CT Holdings, Inc. provides management expertise and capital to early stage companies. At March 31, 2002 the Company held investments in Citadel Security Software, Parago, River Logic and Encore. The Company was incorporated in Delaware in 1992 and previously operated under the name Citadel Technology Inc. Our business model is designed to enable the companies in whom we invest or acquire to become market leaders in their industries. Our strategy over the years has led to the development, acquisition and operation of technology based businesses with compelling valuations and strong business models. We believe that the anticipated growth in technology creates strong opportunities for us to increase shareholder value by investing in well-positioned early stage ventures. Our goal is to realize the value of our investments for our shareholders through a subsequent liquidity event such as a spin-off, sale, merger or initial public offering of the investee companies.

In November 2001 the Company announced a plan to spin-off of its Citadel subsidiary as a special dividend to shareholders of CT Holdings. (See "The Citadel Security Software Distribution and Discontinued Operations" below). The distribution of the Citadel shares is anticipated to close on May 17, 2002, the Distribution Date. While Citadel continues to operate its security software business, generally accepted accounting principles requires that the financial statements of Citadel, previously consolidated with the financial statements of the Company be presented in these financial statements as discontinued operations as of March 31, 2002 and for the three months ended March 31, 2002 and 2001.

THE CITADEL SECURITY SOFTWARE DISTRIBUTION AND DISCONTINUED OPERATIONS

In November 2001, the board of directors of CT Holdings approved the spin-off of Citadel through the declaration of a pro rata dividend distribution to the holders of record of the outstanding shares of CT Holdings common stock (the "Distribution"). The Distribution consists of one (1) share of Citadel common stock for every four (4) shares of CT Holdings (the Distribution Ratio) held by CT Holdings shareholders as of May 6, 2002 (the "Record Date). Following the Distribution on May 17, 2002 (the "Distribution Date"), Citadel will be an independent company and CT Holdings will have no continuing ownership interest in Citadel. The Distribution is intended to be a tax free distribution for U.S. federal tax purposes although neither we nor Citadel have requested or obtained any opinions as to the tax treatment of the Distribution. On the Distribution Date, CT Holdings and Citadel will enter into a series of agreements including a distribution agreement, a transition services agreement and a tax disaffiliation agreement which will provide for, among other things, the principal corporate transactions required to effect the Distribution, to provide for an orderly transition to the status of two independent companies and to define the continuing relationship between Citadel and CT Holdings after the Distribution.

After the Distribution, Citadel will be an independent company, with CT Holdings having no continuing ownership interest in Citadel. Two of five directors of CT Holdings will be directors of Citadel and the Chief Executive Officer and the Chief Financial Officer of CT Holdings will hold the same positions with Citadel. It is expected that 20% to 33% of the officers' time will be allocated to CT Holdings. All other employees of CT Holdings will become employees of Citadel. Under the transition services agreement Citadel will provide accounting, administrative, information management and other services, including the services of the two officers, to CT Holdings in return for a payment of a monthly administrative fee initially estimated at $20,000 per month. The fee may be adjusted quarterly subject to a reallocation of the estimated time devoted to each company.

As a result of the Distribution, the financial statements and the results of operations of Citadel are presented as

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discontinued operations in CT Holdings' financial statements. Summary financial information with respect to Citadel is provided below:

	March 31, 2002	March 31, 2001
Results of operations:		
Revenue	$ 89,276	$ 100,707
Net Loss	(569,582)	(509,779)

	March 31, 2002	December 31, 2001
Balance sheet data:		
Current assets	$ 134,433	$ 171,954
Current liabilities	1,685,507	1,107,647
Property and equipment	40,849	43,006
Capitalized software development costs..	300,285	174,110
Stockholder's (deficit)	(1,192,697)	(693,926)

OVERVIEW OF CITADEL SECURITY SOFTWARE

Citadel develops, markets and licenses a line of desktop and network security software products that address security inside the firewall, a growing segment within the software industry. Citadel's business strategy is to focus its software solutions on the needs and issues of securing computing environments from cyber threat vulnerabilities. Citadel's security software products are generally licensed for perpetual use on standalone personal computers or on single or multiple networks across single or multiple customer computing sites. Its security software solutions, Hercules, WinShield Secure PC and NetOFF, provide network security administrators flexibility and scalability for automating the remediation of network security vulnerabilities, and for managing security policies within their computing environments. These security software solutions operate inside the firewall and are designed to secure computers and networks against unauthorized configuration changes and unapproved software installations and other causes of security vulnerabilities in computing systems.

After the Distribution, Citadel will be an independent public company trading on the Over The Counter Bulletin Board (OTCBB) market under the symbol CDSS, with CT Holdings having no continuing ownership interest in Citadel. Citadel has been allocated the CT Holdings corporate assets, liabilities and expenses related to the security software business based on an estimate of the proportion of such amounts allocable to Citadel, utilizing such factors as total revenues, number of employees and other relevant factors. CT Holdings and Citadel believe that these allocations have been made on a reasonable and consistent basis and that all costs allocated to Citadel are a reasonable representation of the costs that Citadel would have incurred if Citadel had performed these functions as a stand-alone company.

Citadel operates in one business segment of the software industry, security software. Citadel focuses its marketing and licensing activities generally to businesses and organizations that require an enterprise solution to their network security issues. Although not the primary focus, Secure PC and NetOFF have been licensed to individual consumers primarily through Citadel's website. Its security software solutions, Hercules, WinShield Secure PC and NetOFF, provide customers with network security solutions inside the firewall. Customers license Citadel's products for various reasons ranging from a simple need for a security solution (NetOFF) to limit access to an unattended computer, to a desire for centralized computer systems configuration and policies management (WinShield Secure PC), to a concern for internal for external attacks caused by system vulnerabilities and their remediation (Hercules) to preclude such attacks or to meet the mandates of law. Hercules, WinShield Secure PC and NetOFF address the policies mandated by the Health Insurance Portability and Accountability Act (HIPAA) and Gramm-Leach-Bliley legislation, which impose strict security and privacy requirements on personal data in the health care and financial industries, respectively. The direct impact of these laws on revenue is difficult to specifically determine however revenue from healthcare organizations, insurance companies and financial institutions represent approximately 40% and 21% of Citadel's total revenue for the quarters ended March 31, 2002 and 2001, respectively. Citadel expects that increasing concern for security and privacy of personal data will continue to drive revenue from healthcare and financial institutions.

Hercules is a vulnerability remediation software solution that automates the remediation of security vulnerabilities in computing environments, and Citadel believes that it is the only solution that can automatically deploy the appropriate resolution of the vulnerability, and enhance the security administration of the computing environment. Using industry vulnerability assessment scanning tools, security administrators today can identify the security vulnerabilities affecting their computing environments. Examples of security vulnerabilities include among others, unauthorized users, applications or services, passwords that do not expire, hidden viruses or malicious code, security holes in the coding of operating system or application software and improper configurations of operating systems or applications. Remediation may include the elimination of the malicious code, the blocking of an unauthorized user, the time out of a password, the deployment of a vender patch and other solutions to eliminate the security vulnerability. Hercules provides remediation from a central point of control eliminating the need to resolve each vulnerability individually at each site of a network node one-at-a-time. In January 2002 Citadel filed a provisional patent application with respect to the core technologies and intellectual property rights related to its Hercules software. Citadel offers Hercules to its customers under a perpetual license or under a two year subscription license. As part of the perpetual licensing process for Hercules, Citadel requires its customers to enter into a maintenance contract whereby the customer receives vulnerability remediation updates via a connection through Citadel's website to a database of vulnerabilities and their resolution. These services are included in the pricing under the subscription based license model.

Secure PC enforces security policies across workstations and servers from a single point of control across multiple operating systems and platforms. Version 4.21, released in October 2001, provides advanced features allowing security administrators to create, manage and deploy security policies for Windows computing environments. This software tool allows security administrators to proactively set and enforce security policies for their organization across Windows platforms and secures access to information and applications from unauthorized users. Additionally, Secure PC provides hardening of system files that deliver the first line of defense against viruses, malicious code and unauthorized access or theft of confidential information.

NetOFF is designed to protect a network by shutting down unattended client PCs automatically after a specified period of inactivity. Network administrators may also use NetOFF to shut down PCs to enhance backup operations or assist with the distribution of new software, anti-viral updates and to remediate vulnerabilities. The product ensures an orderly shutdown by automatically closing all open files and applications on the PC and saving the information. Version 7.53 was released in February 2001.

In addition to current security solutions offerings, Citadel is also developing additional features and functions for products that it anticipates launching in 2002 including a point release version of Hercules that will broaden the number of third party third party scanning assessment tool interfaces and will include enhanced reporting features. Citadel's product development strategy also includes keeping its products current with the Windows platform changes and migrating its products to UNIX and Linux platforms. As a result of this development strategy Citadel's current security solutions are not subject to rapid changes in consumer preferences or technological obsolescence due to the introduction of new operating systems or computing products. However it is reasonably possible that these factors may change in the future as our business model is adapted to changes in technology, changes in buying patterns of our customers and changes in the software industry's licensing models.

OVERVIEW OF PARAGO

We began our business development activities in January 1999 with the formation of Parago, Inc., an application service provider (ASP) and Internet based business process outsourcer (BPO) that provides a suite of technology offerings (including PromoCenter, ValueRewards and KnowledgeCenter) designed to increase sales, reduce costs, and retain customers for retailers, manufacturers and service organizations. Parago's continuous customer interaction services include online promotional management (including online rebate processing), proactive email, online surveys, and customer data analysis and reporting. Through December 2001, Parago had received approximately $96.3 million in private equity financing from venture capital investors including TH Lee Putnam Ventures, Dain Rauscher Wessels Investors, Watershed Capital and Seaboard Ventures, as well as angel investors. CT Holdings continues to hold 20,000 shares of Parago common stock and warrants to purchase 28.8749 shares of Parago's Series A-3 Preferred Stock (convertible into 2,887 shares of Parago's common stock).

Parago provides Internet-based solutions that automate customer relationship management. Parago's solutions enable both brick-and-mortar and e-commerce businesses to more efficiently develop, retain and extend customer relationships and improve sales, marketing and customer retention. Parago's Internet-enabled enterprise solutions include PromoCenter, ValueRewards and KnowledgeCenter. By automating customer care activities such as online and traditional rebate processing and promotions, Parago allows its clients to enhance customer retention, increase revenue opportunities and improve operating efficiencies. Parago's Internet-based solutions seek to transform promotional management and product information from customer service liabilities to retention and extension opportunities.

Parago's online solutions provide a vehicle for its clients to conduct targeted marketing to customers with whom they have traditionally lost contact subsequent to the point of purchase. Parago is developing proprietary software that will provide an online mechanism for customers, many of whom have immediate purchasing power in the form of promotional proceeds, to apply those proceeds towards the purchase of additional products or services. Parago's solutions also capture valuable customer information that can help its clients better understand customer behavior. Parago plans to provide fee-based customer specific or aggregated data analyses to assist clients in designing future promotions. Parago's solutions also enable businesses to improve operating efficiencies by allowing them to analyze the results of their promotions and manage these promotions on a real time basis. Parago markets its solutions to retailers, manufacturers and service providers across multiple industries.

In connection with an acquisition by Parago in March 1999, we agreed to convert the Parago shares of common stock issued in connection with the merger into up to 500,000 of our shares at the option of the shareholders of the Company acquired by Parago. In May 2002 the Company exchanged 139,806 shares of the Company's common stock for 1,200 shares of Parago common stock with some of these shareholders. In addition, pursuant to the terms of the subscription agreements between Parago and some of its stockholders, we may be required to issue up to 414,000 shares of our common stock to such stockholders based upon a conversion price of $3.75 per share. In May 2002, the Company exchanged 16,000 shares of the Company's common stock for 40 shares of Parago common stock with one of these shareholders. These provisions could have the effect of diluting our stockholders.

After a 1 for 1000 reverse stock split by Parago in connection with its Series E preferred stock offering in December 2001 to February 2002, in which the Company elected not to participate, the Company holds 20,000 shares of common stock of Parago and warrants to purchase 28.8749 shares of Parago's Series A-3 Preferred Stock (convertible into 2,887 shares of Parago's common stock) at March 31, 2002. In December 2001 Parago completed the first closing ($13.6 million) of an equity financing of approximately $15.0 million. Approximately $1.4 million of equity financing was closed in February 2002. As a result of the equity financing our ownership percentage in Parago was reduced to approximately 1%. Our investment in Parago for the period from January 1, 2001 through December 12, 2001 and the ten months ended December 31, 2001 was accounted for under the equity method of accounting for investments and accordingly as a result of our ownership falling below 20%, has been accounted for using the cost method of accounting since December 13, 2001. Under the cost method of accounting, the Company's share of the income or loss from Parago is not included in operations. Under the equity method of accounting, the Company's share of the investee's income or losses is included in the statements of operations. If the carrying value of the Company's net investment falls below zero, the Company discontinues applying the equity method until the carrying value of the net investment rises above zero. In addition, in the event the Company's ownership percentage exceeds 20% and the value of the Company's equity investment rises above zero, the Company will resume applying the equity method and will recognize an investment in Parago after the Company's share of net losses not recognized is recovered through our proportionate share of net income if Parago turns profitable. While Parago continues to incur operational losses we believe that our $50,000 investment in Parago represented by 20,000 shares of Parago's common stock (plus 1,240 shares to be received from the exchanges in May 2002) and warrants to purchase 28.8749 shares of Series A-3 preferred stock (convertible into 2,887 shares of Parago common stock) may ultimately provide an appropriate return.

OVERVIEW OF RIVER LOGIC

In May 2000, we made an investment in River Logic by acquiring shares of common stock of River Logic from several of its existing shareholders in exchange for 333,333 shares of our common stock. We also acquired shares of Series A Convertible Preferred Stock ("Series A") from River Logic in exchange for the contribution of assets

acquired from a third party by the Company through exchange of 666,667 shares of our common stock. In connection with the investment in River Logic, we also made two bridge loans totaling $600,000 to River Logic that were convertible into shares of capital stock of River Logic. Each of the bridge loans (i) bears interest at a rate of 12% per annum through its first anniversary and at one percent above the prime rate per annum thereafter, (ii) is secured by certain assets of River Logic, (iii) is payable upon the Company's demand and (iv) is repayable by River Logic commencing on its third anniversary date. In addition, we also incurred cash expenses for professional fees related to these transactions and we issued 50,000 shares of our common stock to a consultant for identifying this investment. After the closing of the transaction the consultant became the Chief Operating Officer of River Logic and we granted him 100,000 fully vested options to purchase our common stock at $5 per share (which was above the fair market value at the date of issuance).

In April 2001, River Logic received a strategic investment from the Intel 64 Fund, Cardinal Investment, Inc, eMed Ventures and Mercury Ventures, and the Company converted $450,000 of the principal amount of the notes into shares of the Series C Preferred Stock, and River Logic repaid the $216,000 balance of these notes plus interest in April 2001.

The carrying value of the River Logic investment is approximately $2.7 million representing an ownership percentage of approximately 12%. Our investment in River Logic is accounted for using the cost method of accounting for investments in common stock.

CRITICAL ACCOUNTING POLICIES

Our discussion and analysis of our financial condition and results of operations are based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. On an on going basis, we evaluate our estimates, including those related to our investments in our investee companies and commitments and contingencies. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies are most important to the presentation of our financial statements and require the most difficult, subjective and complex judgments.

Impairment Charges

We periodically evaluate the carrying value of our ownership interests in our investee companies for possible impairment based on achievement of business plan objectives and milestones, the value of each ownership interest in the investee company relative to carrying value, the financial condition and prospects of the investee company, and other relevant factors. The business plan objectives and milestones we consider include, among others, those related to financial performance such as achievement of planned financial results or completion of capital raising activities, and those that are not primarily financial in nature such as obtaining key business relationships or the hiring of key employees.

If an indication of impairment exists with respect to the carrying value of an investee company, we perform an evaluation by comparing the estimated fair value of the asset with its carrying value. Fair value is determined by estimating the cash flows related to the asset, including estimated proceeds on disposition, if any. If the fair value is less than the carrying value a loss is recorded.

Deferred Income Taxes

We record a valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized. We consider future taxable income and prudent and feasible tax planning strategies in determining the need for a valuation allowance. In the event that we determine that we would not be able to realize all or part of our net deferred tax assets, an adjustment to the deferred tax assets is charged to earnings in the period such

determination is made. Likewise, if we later determine that it is more likely than not that the net deferred tax assets would be realized, then the previously provided valuation allowance would be reversed.

Commitments and Contingencies

From time to time, we are a defendant or plaintiff in various legal actions, which arise in the normal course of business. We are also a guarantor of various third-party obligations and commitments. We are required to assess the likelihood of any adverse judgments or outcomes to these matters as well as potential ranges of probable losses. A determination of the amount of reserves required for these contingencies, if any, which would be charged to earnings, is made after careful analysis of each individual issue. The required reserves may change in the future due to new developments in each matter or changes in circumstances, such as a change in settlement strategy. Changes in required reserves could increase or decrease our earnings in the period the changes are made.

Effect of Various Accounting Methods on our Results of Operations

The various interests that we acquire in our investee companies are accounted for under three broad methods: consolidation, equity method and cost method. The applicable accounting method is generally determined based on our percentage ownership in an investee company.

Consolidation Method: Investee companies in which we directly or indirectly own more than 50% of the outstanding securities or those where we have effective control are generally accounted for under the consolidation method of accounting. Under this method, an investee company's accounts are consolidated within our financial statements. Participation of other unrelated stockholders in the earnings or losses of a consolidated investee company would be reflected as a minority interest in consolidated financial statements. Minority interest adjusts our consolidated net results of operations to reflect only our share of the earnings or losses of the consolidated investee company. At December 31, 2001 and 2000 we had no investee company qualified for this accounting method.

Equity Method: Investee companies whose results we do not consolidate, but over whom we exercise significant influence, are generally accounted for under the equity method of accounting. Whether or not we exercise significant influence with respect to an investee company depends on an evaluation of several factors including, among others, representation on the investee company's board of directors and percentage ownership level, which is generally a 20% to 50% interest in the securities of the investee company, including our holdings in common, preferred and other convertible instruments in the investee company where we may have voting rights. Under the equity method of accounting, an investee company's accounts are not reflected within our financial statements; however, our share of the earnings or losses of the investee company is reflected in our statements of operations.

Cost Method: Investee companies not accounted for under either the consolidation or the equity method of accounting are accounted for under the cost method of accounting. Under this method, our share of the earnings or losses of these companies is not included in our statements of operations.

RESULTS OF OPERATIONS

QUARTER ENDED MARCH 31, 2002 COMPARED WITH QUARTER ENDED MARCH 31, 2001

CT Holdings' continuing operations consists of costs and expenses from providing services to our investee companies and the activities to identify additional technologies and companies in which CT Holdings might invest. While Citadel continues to operate its security software business, the financial statements of CT Holdings' wholly owned subsidiary, as of March 31, 2002, Citadel, are presented as discontinued operations in all periods to reflect the dividend distribution to CT Holdings' shareholders and spin off of the business as a separate company on May 17, 2002, the Distribution Date. In 2000 our investment in Parago was reduced to zero as a result of our share of cumulative losses since our initial investment was made in Parago. Also an additional investment in Parago by unrelated third parties has caused our ownership percentage to fall below the 20% ownership threshold required to account for the investment under the equity method and accordingly we record our investment in Parago using the cost method. Our investments in River Logic and Encore are also recorded using the cost method.

Loss from continuing operations for the quarter ended March 31, 2002 includes legal and administrative costs and

the costs of shared personnel and office costs. Loss from continuing operations for the quarter ended March 31, 2001 consists of the costs and expenses maintaining and office and legal and administrative expenses. Cost and expenses related to the Citadel security software business have been allocated to Citadel based on an estimate of the proportion of amounts allocable to Citadel utilizing such factors as revenues, number of employees, and other relevant factors.

General and Administrative Expenses

We had general and administrative expenses for the quarters ended March 31, 2002 and 2001 of $454,070 and $161,440 respectively, an increase of $292,630, or 181%. The increase is primarily a result of legal fees associated with ongoing legal matters and defense costs related to the various legal claims and consulting fees associated with business development and incubator activities.

Interest and Other Income (Expense)

Interest expense for the quarters ended March 31, 2002 and 2001 was $37,932 and $4,507, respectively. The increase of $33,425 is primarily due to the recognition of $25,650 of interest expense associated with the beneficial conversion feature of a convertible note and higher average balance of debt outstanding during the quarter ended March 31, 2002. No interest income was earned in the quarter ended March 31, 2002. The $21,250 of interest income for the three months ended March 31, 2001 represents interest on notes receivable during the period.

Net Loss

As a result of these factors, for the quarters ended March 31, 2002 and 2001 we reported a loss from continuing operations of $492,002 and $144,697. The loss from discontinued operations related to Citadel for the quarter end was $629,582 and the Company also incurred transaction costs of $158,717 related to the Distribution during the first quarter of 2002 which are shown as costs in connection with spin off of subsidiary. This compares to a loss from discontinued operations of $509,779 for the quarter ended March 31, 2001.

LIQUIDITY AND CAPITAL RESOURCES

The Company has incurred recurring operating losses and has a significant working capital deficiency at March 31, 2002. Cash used in operations was approximately $289,000 during the three months ended March 31, 2002. The Company had no cash balance at March 31, 2002 and current liabilities exceed current assets from continuing operations by approximately $2.1 million. Immediate funding needs of the business are expected to be provided by financings through short-term notes payable and additional investments from related parties.

In May 2002 the company negotiated the settlement of approximately $826,000 of operating liabilities in exchange for 1,575,000 shares of common stock of the

Company. The creditors associated with these liabilities are shareholders of record on the Record Date and will receive the dividend of the Citadel common stock to be distributed on or about May 17, 2002. The settlement transactions will be accounted for pursuant to FAS 15 - Accounting for Debtors and Creditors for Troubled Debt Restructurings and accordingly a net gain of approximately $433,000 on the restructuring of payables representing the difference between the fair value of the Company's common stock issued and the recorded value of the liability will be recorded. The fair value of the Company's common stock has been determined as the closing price ($0.25) on the OTCBB for May 1, 2002, the day before the ex-dividend date, the last day the Company's common stock was traded and quoted with the value of the dividend included.

Also in May 2002 the Company issued 6,500,000 shares of the Company's common stock pursuant to the exercise of stock options in return for $1,307,500 in promissory notes to the Company secured by the shares issued to the option holders. In addition, 147,500 shares of the Company's common stock were issued to option holders as a bonus in lieu of payment of $29,500 for the exercise price for those options. The Company issued 100,000 shares of common stock to an individual for $25,000 in cash.

The Company has been and continues to be dependent upon outside financing to perform its business development activities, make investments in new technology companies and to fund operations. During the quarter ended March 31, 2002, related parties provided substantially all of this financing. Future cash may come from the realization of

the value of our investments in Parago, River Logic and Encore however there can be no assurance that any value will ever be realized from these investments. (See below).

The Company's strategy of continuing to support and expand its business development activities will not generate positive cash flow in the foreseeable future. The complete implementation of this element of our strategy requires the Company to obtain additional capital. Achieving positive cash flow is currently highly dependent upon obtaining liquidity from the Company's investments in unconsolidated affiliates. The Company estimates it will need to raise $500 thousand to $1 million to support its incubator and business development activities through the remainder of 2002. Historically, the Company has obtained short-term bridge funding from its Chief Executive Officer or Directors of the Company. While this may occur in the future there can be no assurance that such financing will be available or if available with terms that the Company would be willing to accept.

The Company has made investments in entities that it believes may provide liquidity to the Company in the long term. The Company believes that its investment in Parago has been successful with Parago having had no revenue at the time of the Company's initial $50,000 equity investment, growing to audited net revenue of approximately $26 million for the year ended December 31, 2001. As expected in an early stage company, Parago has not been profitable and has experienced cash flow deficiencies as it implements its business plan. During 2001 the Company's percentage ownership in Parago was reduced to approximately 1% as a result of an additional equity financing raised by Parago in December 2001. The Company believes, however, that its remaining investment of 20,000 common shares of Parago (following a 1-for-1000 reverse stock split) and warrants to purchase 28.8749 shares of Series A-3 preferred stock (convertible into 2,887 shares of common stock) may ultimately provide an appropriate return on its initial investment of $50,000.

Similarly, the Company believes its investment in River Logic has also been successful. Since our initial investment, River Logic has made progress in executing its strategy through its development and introduction of new products and establishment of new customer relationships. In addition, during April, 2001 River Logic obtained a significant strategic investment from the Intel 64 Fund, Cardinal Investments, eMed Ventures, and Mercury Ventures. Similar to the investments into Parago, the Company recognized that this investment would be initially illiquid. The Company's minority position in Encore is immaterial and is not expected to provide liquidity to the Company in the foreseeable future. While the Company is pleased with the performance of its investee companies to date, there can be no assurance that the Company will ever achieve liquidity for its investments.

There can be no assurance that management's plans will be successful or what other actions may become necessary. Until the Company is able to create liquidity from its investments through sale to a strategic investor, an initial public offering or some other liquidity transaction, the Company will continue to require working capital to fund its own operating expenses. Although the Company has been successful raising capital in the past, the inability of the Company to raise capital may require the Company to sell assets or reduce the level of its operations. Such actions could have a material adverse effect on the Company's business and operations and result in charges that could be material to the Company's business and results of operations.

All cash and cash equivalents at March 31, 2002 and 2001 were allocated to the Citadel Security Software business shown as discontinued operations in the CT Holdings financial statements due to the Distribution anticipated to be completed on May 17, 2002. Unless otherwise noted all amounts discussed below are from the continuing operations of CT Holdings represented by its business development and incubator activities. The net cash used in operations of $289,255 for the quarter ended March 31, 2002 is principally a result of the loss from continuing operations of $492,002, and the changes in operating assets and liabilities of $331,666 primarily consisting an increase in accounts payable and accrued expenses. In the quarter ended March 31, 2001 there was cash used in operating activities of $3,037 consisting of a loss from continuing operations of $144,697 and changes in operating assets and liabilities of $141,660.

There was no cash flow from investing activities in the quarter ended March 31, 2002. This compares to $78,500 of cash provided from the proceeds of notes receivable in the quarter ended March 31, 2001. Cash flows provided by financing activities was $360,066 for the quarter ended March 31, 2002, primarily resulting from the proceeds of notes and advances payable from related parties of $519,000 offset by payments to related parties of $158,935.

As a result of the aforementioned factors, net cash provided by continuing operations was $70,811 and $75,463 for

the quarters ended March 31, 2002 and 2001 respectively. The net contribution by CT Holdings to Citadel was $70,811 and $75,463 for the same quarters, respectively. The net result was no cash balance to the Company.

Because of the filing of a Form 10-SB in January 2002, on March 11, 2002 Citadel Security Software became a reporting company under the Securities Exchange Act of 1934 upon expiration of the statutory sixty day period. Accordingly revenues and expenses related to the security software business will be recognized and reported by Citadel in filings separate from CT Holdings' filings. CT Holdings will continue to reflect Citadel's business as discontinued operations until the completion of the Distribution on May 17, 2002.

In the future, CT Holdings will incur expenses relating to corporate overhead related to the execution of its business model and the operations of businesses acquired. The Company will require cash from financing activities to fund the deficits expected over the next year. The Company's operation requires the Company to obtain additional capital. The Company will need to raise additional capital to fund its incubator and business development activities through 2002. Historically, the Company obtained short-term bridge loans from its Chief Executive Officer or Directors of the Company. The Company has been and continues to be dependent upon related party financing to fund its business development and incubator activities. During the quarter ended March 31, 2002 and year ended December 31, 2001, related parties have provided substantially all financing and management will continue to rely on related parties to fund future operations. We may need to rely on similar funding from related parties for future funding needs. While this may occur in the future there can be no assurance that such financing will be available or if available, on terms the Company would be willing to accept. There can be no assurance that management's plans for CT Holdings incubator business model will be successful or what other actions may become necessary. Although the Company has been successful raising capital in the past, the inability of the Company to raise capital may require the Company to sell assets or reduce the level of its operations. Such actions could have a material adverse effect on the Company's investee companies, its business or operations and may result in charges that could be material to the Company's business and results of operations. The Company has no material purchase commitments for property and equipment at March 31, 2002.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Set forth below are litigation matters to which we are a party. We believe that we have meritorious defenses and will vigorously defend ourselves. However, an unfavorable resolution of, settlement, or defense costs related to one or more of these lawsuits could have a material adverse effect on our business, results of operations or financial condition.

In June 2000, CT Holdings was served with a lawsuit filed in state court in Houston, Texas by Michael and Patricia Ferguson for breach of contract, tortious interference and negligence. Specifically, the Fergusons claim that they were damaged when they attempted to exercise warrants during a time when CT Holdings' related registration statement could not be used. CT Holdings believes that the claims asserted by the Fergusons are without merit and will vigorously defend the claims. The trial in this case was held from April 22, 2002 until May 1, 2002, and the Company is awaiting the judgment from the trial court.

We may become involved from time to time in litigation on various matters which are routine to the conduct of our business. We believe that none of these actions, individually or in the aggregate, will have a material adverse effect on our financial position or results of operations, though any adverse decision in these cases or the costs of defending or settling such claims could have a material adverse effect on our business.

Item 2 - Changes in Securities and Use of Proceeds

Recent Sales of Unregistered Securities

During the quarter ended March 31, 2002, we issued 12,500 shares of common stock in lieu of cash compensation to a consultant who is now Chief Financial Officer of the Company. In May 2002 we agreed to sell 100,000 shares of common stock at $0.25 per share the closing price as quoted on the Over The Counter Bulletin Board for May 1, 2002. The shares were issued pursuant to the exemption from registration contained in Section 4(2) of the Securities Act of 1933.

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.

CT HOLDINGS, INC.

(REGISTRANT)

Date: May 20, 2002 By: /s/ STEVEN B. SOLOMON

Steven B. Solomon,
President and Chief Executive Officer
(Duly Authorized Signatory and Principal Executive Officer)

/s/ RICHARD CONNELLY

Richard Connelly,
Chief Financial Officer
(Duly Authorized Signatory and Principal Accounting and Financial Officer)