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Sent: Fri 11/7/2008 1:16 AM
To: cfalvey@cpsec.gov
Cc: Michael Gidding (mjg@brown-gidding.com); nnord@cpsec.gov; jmartyak@cpsec.gov;
judith.bailey@mail.house.gov
Subject: The Financial Consequences of Retroactive Application of the CPSIA

Dear Ms. Falvey,

Per our conversation today, I am writing you to express my deep concern over the dire financial consequences of your office's September 12th legal opinion ("September 12th Opinion") that the new safety standards of the CPSIA apply retroactively to existing inventory.

It is unfortunate that so many people misread the issue of "financial consequences" to refer simply to the cost of the inventory. Yes, as covered in detail in today's panel discussion, companies in the chain of commerce (manufacturers, distributors and retailers) have little practical ability to make existing inventory "go away". In that sense, the retroactive application of the CPSIA is in fact disastrous. Yet, the implications of the September 12th Opinion are far deeper and more threatening. A necessary result of the purported retroactive effect of the CPSIA on existing inventory will be (a) widespread defaults under loan agreements as of February 10, 2009, (b) widespread failures to obtain audited financial statements for 2008 (another loan default issue), and (c) for public companies, an immediate Sarbanes-Oxley disclosure issue stemming from these problems. Defaults under loan agreements may result in the reduction or termination of available credit to operating companies. It can also trigger cross-defaults among related entities or related agreements, causing even more far-flung financial destruction. For many family businesses, this could result in a total wipeout of all family wealth in one fell swoop.

While these financial consequences have received little attention to date, their potentially highly toxic effect should not be ignored.

Loan Defaults: The typical American company finances its operations with asset-based loans. In this kind of loan, lenders agree to advance a percentage of "Eligible Inventory" as a revolving loan. In other words, the loan floats up and down over its term as the borrower meets its daily cash needs, but overall availability is limited by the value of inventory. The size of borrowing availability is determined each month based on representations called "Borrowing Base Certificates" in which the borrower attests to the value of its inventory, and then makes various representations relating to the definition of "Eligible Inventory". I have attached a typical definition of "Eligible Inventory" for your review. Please note subparts (b) and (e), as well as the final paragraph. Subparts (b) and (e) cannot be attested to after February 9, and under the terms of the last paragraph of the definition of "Eligible Inventory", an undetermined amount of inventory would no longer be "eligible". In addition, the ongoing representation of the typical borrower that they are operating in compliance with law can no longer be made. This has implications for the Borrowing Base Certificate, see below.

In a typical Borrowing Base Certificate, the following language typically appears:

"Pursuant to the terms of that certain [Loan Agreement], we submit this Borrowing Base Certificate to you and certify that the information set forth below and on any attachments to this Certificate is true, correct and complete as of the date of this Certificate. . . . The undersigned hereby certifies that the above information and computations are true and accurate and hereby represents and warrants that as of the date hereof, (i) no Event of Default or Unmatured Event of Default under the Credit Agreement has occurred or is continuing, (ii) the representations and warranties of the Borrower set forth in the Credit Agreement are true and correct in all material

respects as of the date hereof, and (iii) the Borrower is in compliance with the covenants set forth in the Loan Agreement."

Any Borrowing Base Certificate with such language after February 9 may not be executed by anyone intent on selling or placing a positive value on inventory existing on February 9. An inability to sign a Borrowing Base Certificate or signing a Borrowing Base Certificate with fraudulent intent is clearly a serious default under any loan agreement.

Consequences of Loan Defaults: Even a technical default must be resolved between borrower and lender. In this case, lenders will have three basic options for action: (a) levy fees to cure or waive the default (this is a typical provision in many loan agreements), (b) insist that the loan agreement be renegotiated, likely to reduce borrowing availability based on a new, lower advance rate on Eligible Inventory, and/or (c) an outright and possibly immediate refusal to lend. Notably, if existing inventory continually becomes contraband under the September 12th Opinion as lead and lead-in-paint standards ratchet down over time, this cascade of defaults will repeat again and again.

It can be anticipated that many companies will find credit declining or terminated as a result of these defaults. This will have a dramatic effect on these companies' investable capital and their ability to maintain a stable workforce.

Audited Statements: Many loan agreements require audited financial statements at the end of every year. All public companies provide audited statements. In preparing audited statements, independent accountants will insist on "testing" inventory valuations. Furthermore, they will take into account events occurring after the close of the period, as such events could expose misleading information in the financial statements for the current period. In the case of retroactive effect on existing inventory, the pending change in valuation of inventory as of February 10, 2009 will make it impossible to certify 2008 financials without serious and negative qualifications (if at all). This failure would have an immediate effect on any company under its loan agreement (and in the public markets, if applicable), resulting in reduction or termination of available credit. Recent events on Wall Street demonstrate the serious threat posed by sudden losses of available credit, and the consequential financial destruction and loss of jobs.

Sarbanes-Oxley: The financial implications above clearly constitute a material financial event and create immediate issues under Sarbanes-Oxley for any public company. The fact that this issue has not yet been disclosed by any public company is troubling and potentially creates personal liability for many public company officers, including possible criminal liability.

The conclusion that the CPSIA applies retroactively to inventory is an inherently technical legal matter, involving detailed analysis of unbending rules of law. It should be no surprise then that equally technical financial issues emerge in its wake based on precise readings of unbending contracts and GAAP rules. In this case, the above financial/contractual issues are real and will get the attention of the financial community. Lenders have no incentive to be "understanding" in their appreciation of the CPSIA or its good intentions. Good intentions don't repay loans, and contraband inventory makes for poor collateral. And once lenders are provided with an incentive to act (to preserve their own capital), the dominoes will start to topple - ending where? ending how?

The CPSC needs to reconsider its opinion urgently and to render a clean, clear and well-publicized opinion that the CPSIA does NOT apply retroactively to existing inventory. Time is of the essence.

Thank you for considering my view on this important topic.

Sincerely,

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