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Subject: CPSIA - National Bankruptcy Day Redux

Yesterday, two events took place that ensure the devastation of many American businesses, namely the decision by Judge Paul Gardephe of the U.S. District Court for the

Southern District of New York (08 Civ. 10507 PGG) to overturn the legal opinion of Cheryl Falvey and establish a virtually immediate retroactive nationwide ban on phthalates on February 10 (the NRDC Case), and the rejection of the National Association of Manufacturers' petition to stay the new lead standards by a vote of the CPSC Commissioners 2-0. While the latter outcome was expected (see the legal analysis in my email dated February 4 entitled "CPSIA – The Blame Game"), the NRDC Case decision was unexpected and is a huge setback to any rational implementation of this law. The decision raises anew the prospect of a National Bankruptcy Day on February 10.

On November 7, I wrote an email to Cheryl Falvey, General Counsel of the CPSC, documenting the potential of her retroactivity opinion (on lead) to cause widespread loan defaults among American businesses. I have reproduced the November 7 email below and in an attachment. My warnings of dire consequences from the lead ban have been ignored, but courtesy of the NRDC Case, we will soon find out if I was right. With two business days to go, and no advance warning, American retailers and manufacturers will be caught with massive inventories of product which they had been assured was legal to sell (opinion of Cheryl Falvey dated November 17, 2008) but which will now become contraband on February 10. The ability of such companies to comply with their asset-based loan agreements is now in question. Likewise, the decision in the NRDC case creates an overnight Sarbanes-Oxley disaster for the SEC as countless public financial statements instantaneously become materially misstated. It will be most interesting to see how the banks respond to this Congressionally-induced crisis. I am cc'g this email to Jamie Dimon, the CEO of JPMorgan Chase, whose loan documents are abstracted in the attachment, so the bank can begin to review its options. Another financial crisis for American banks, how exciting for the American public!

You have demonstrated that you are not interested in contrary opinions of your law. In my February 4 email, I explained how the mechanics in your law, the CPSIA, prevents the CPSC from using its judgment and discretion to implement the new law. Interestingly, the letter of Acting Chairman Nancy Nord to Representative Henry Waxman et. al. dated January 30 (see attached) echoes my analysis of the law. As she notes:

> "[We] are struggling, and impacted industries are struggling, with the requirements of the CPSIA as they relate to various products, such as bicycles, car seats, shoes and books, that may or may not have been intended to be so broadly impacted by the legislation. We are also working hard to find common sense solutions to some of the scenarios that have been raised in cases where public health is not endangered. As we work through these many issues, the staff has found that the requirements of the new law are inflexible, are not sequenced to maximize effectiveness and generally limit our options. Action by BOTH the Commission and the Congress is needed to address these issues. . . . It especially should be emphasized that because we cannot change the retroactive effect of the lead ban to existing inventory, [the stay on testing and certification] will not provide relief to the charities, thrift stores and other small retailers who must still meet the standards enacted by Congress. [Ed. Note: With the decision in the NRDC Case yesterday, this warning now applies to phthalates, as

well.] To effect this change, Congress will need to amend the statute." [Emphasis added]

The response to this letter was swift – by letter dated February 3, Representative Waxman et. al. requested that President Obama urgently replace Ms. Nord. Thus it appears that silencing Commissioner Nord is the preferred response to her comments on the inner workings of the CPSIA. The Congressional leadership's intolerance of dissent is outrageous. As stated in Representative Waxman et. al. state in their February 4 letter (see attached), "everyone agrees" that the new standards are "critical" to protect children. See no evil, hear no evil . . . . The substance of Commissioner Nord's arguments, and my arguments, remain entirely unanswered.

The business losses from the implementation of the CPSIA will make February 10 a dark day in American economic history. I have no idea how many business closings will result or when they will happen, and have no interest in promoting that sort of speculation. It is, however, NO speculation that business losses will be severe and entirely the responsibility of Congress during a time of severe financial and economic crisis. House and Senate leadership made certain that businesses will be hobbled, crushing the employees, customers and communities of the affected companies. The gloating self-satisfaction of supporters of this bill (see, e.g., http://www.nrdc.org/media/2009/090205a.asp) will soon backfire as the American public comes to recognize the carnage done by "do-gooders". As before, I assert that this law will touch an estimated 60% of the U.S. economy in one way or another.

The economic impact of the CPSIA making will become manifest over time, not with a Big Bang on February 10 but slowly building and revealing itself long after the damage is irreversible. Those who arrogantly dismissed the protests of the MANY responsible and law-abiding people subject to this unfair law as "misguided" or "misinformed" will be held to account when the wreckage becomes clear. As you vote this week to print up a quick $800 billion to resurrect the economy, please remember to take ownership of your simultaneous action to destroy an important part of it.

You have brought this disaster on your voters, and we will remember how you responded to our pleas. I hope you will finally listen to the substantive and legitimate criticism of this disastrous law and use this last opportunity to stay the effectiveness of the CPSIA, thus allowing more time for hearings, further debate and rulemaking, and a rational, fair and orderly implementation of your groundbreaking safety program. There are two business days to go – the time to act is NOW.

Sincerely,

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See my blog at http://learningresourcesinc.blogspot.com/ or at www.twitter.com/rwoldenberg

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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 availablility 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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