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UNITED STATES DISTRICT COURT

CENTRAL DISTRICT OF CALIFORNIA

FEDERAL TRADE COMMISSION,

Plaintiff,

v.

TELESTAR CONSULTING, INC., also d/b/a Kleritec and United Business Supply; and KARL WESLEY ANGEL, individually and as a principal of Telestar Consulting, Inc.,

Defendants.

Case No. LACV16-00555 SJO (SSX)

PRELIMINARY REPORT OF RECEIVER

JUDGE: Hon. S. James Otero
CTRM: 1

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PRELIMINARY REPORT OF RECEIVER

I.

INTRODUCTION

On February 2, 2016, this Court entered its Amended Temporary Restraining Order with an Asset Freeze ("TRO") that appointed me as the Receiver for the business activities of Receivership Defendant Telestar Consulting, Inc. ("Telestar"), also doing business as Kleritec and United Business Supply. The TRO also restrains Defendants from the prohibited conduct alleged by the Federal Trade Commission ("FTC") – i.e., unlawful telemarketing sales practices of shipping products without consumer authorization or an agreement on all terms of sale.

I submit this Preliminary Report in compliance with Section XVI of the TRO which directs that I report on the following topics prior to the Preliminary Injunction hearing:

1. <u>Steps taken to implement the TRO</u>: I indefinitely suspended Receivership Defendant's operations as they are impacted by practices prohibited by the TRO. *See* Section II(F) *infra*.

2-3. <u>Receivership Defendant's assets and liabilities</u>: The Receivership Defendant has meaningful assets in real property, cash, inventory, accounts receivables, intellectual property, and the benefit of operating from a building it owns. We cannot yet estimate liabilities. *See* Sections II(B) and IV *infra*.

4. <u>Steps Receiver intends to take to protect assets of the Receivership Defendant, pursue assets from third parties, and adjust liabilities</u>: The asset freeze and receivership control of the business property are the primary immediate vehicles to protect assets. Whether third parties have assets that can be claimed by the receivership and whether liabilities can be adjusted will require further investigation.

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5. Whether the business of the Receivership Defendant can be operated lawfully and profitably: Given that product quality is not the issue driving the FTC action, this could be a lawful business compliant with the TRO if the unlawful telemarketing sales practices were terminated and compliant sales practices instituted. However, such a sales compliance endeavor appears moot as Defendants have indicated they are prepared to cease telemarketing sales and adopt a sales model not reliant on telemarketing.

Another issue is whether consumer payments presently on hand may be accepted and whether existing accounts receivable may be collected lawfully. We believe that will be possible as to some (but not all) payments received and outstanding receivables, but only after careful vetting to exclude payments and receivables tainted by prohibited practices and unlawful collection tactics.

Lastly, assuming operations are resumed under a new model, profitability is a more complex issue. It is dependent on the success of Defendants' pivot to a lawful sales platform, which would require an arrangement, either by consent decree and/or court order that would authorize capital and financing. *See* Section V *infra*.

6. Any other matters which the Receiver believes should be brought to the Court's attention: These matters are set forth below.

II.

RECEIVERSHIP ACTIVITIES

A. Defendants' Sites

Pursuant to Section XII of the TRO, at approximately 11:30 a.m. on February 3, 2016, we took possession of the primary business premises of Receivership Defendant at 15823 Monte Street, Sylmar, California, and, thereafter, secured and/or spoke with personnel onsite at small sales offices in Carlsbad, California, Chicago, Illinois, and Bradenton, Florida. At the Sylmar site, we

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coordinated our efforts with attorneys and investigators from Plaintiff FTC and uniformed police from the Los Angeles Police Department.

15823 Monte Street, Sylmar, California

At our arrival, Defendant Karl Angel and 28 employees were onsite. We first met with Mr. Angel, who assisted in gathering the employees for a group presentation.

Members of my team commenced interviews with employees individually and in small groups and coordinated with them to remove their personal property. All employees completed questionnaires. Midway through this interview process, Mr. Angel's just-retained counsel requested that interviews be terminated. In response to that request, we terminated the interviews and the employees left. After further discussions with Mr. Angel's counsel, we subsequently met with specific employees as needed on specific tasks.

Telestar, doing business as Kleritec, occupies three contiguous suites in an industrial building in a business park in Sylmar, plus a spillover warehouse in the same complex rented at $500 per month. Telestar is the owner of the three suites, legally identified as office condominiums, purchased in 2010 for $1.9 million. The mortgage on the office condominiums has been paid off.

The ground floor is comprised of the warehouse and shipping department (three employees), administrative departments loosely described as Collections and Customer Service (six employees), Front Office (six employees and the General Manager), several conference rooms, and a show room for product presentations.

The second floor houses a large office for Mr. Angel, most Kleritec sales personnel, and a conference/training room. Sales personnel are divided up by product line – Arts & Crafts, Medistaph, and WIC – and by type of orders – initial orders (aka "front orders") and reorders. Eight personnel were assigned to Arts & Crafts, five to Medistaph, and one to WIC. Except WIC (where one person handled initial orders and reorders), a limited number of long-time employees were authorized to initiate reorders – Mr. Angel and two others. One of those two had just recently been terminated. The other was still on the payroll, but Mr. Angel later told us he would not return to the company if it reopened based on conduct he had seen in the FTC's evidence in support of the TRO.

A locksmith changed the locks in order that the premises remain subject to the Receiver's control.

Appendix, Vol. I, Exhibit 1 is a schematic for the offices, an inventory of furniture and equipment onsite, and current inventory of saleable product.

Carlsbad, California

On February 8, 2016, the Receiver travelled to the small office maintained by Kleritec sales representative Gary Marshall in Carlsbad. Mr. Marshall has operated as a remote sales office for Kleritec (and its predecessor) for more than a decade, focusing on Medistaph initial orders. He is compensated by commission both for initial sales and reorders, although he has no involvement in the reorder process.

Chicago, Illinois

My counsel contacted sales representative Ramona Salam who works out of her home in Chicago, Illinois. She was only involved in initial sales of Kleritec Arts & Craft products based on cold calls. At some point, Kleritec provided her scripts, but she reported that she had developed her own style. She had worked for Kleritec (and its predecessor, United Business Supply) for more than a decade. She was paid a flat fee commission of $50 per sale and reported to us that she generally averaged about three sales a day.

Bradenton, Florida

My counsel contacted Robyn Cole who had operated as a sales representative for Kleritec (and its predecessor) from her home in Bradenton, Florida for more than a decade. Her sales were limited to initial sales of Arts & Crafts. Based on our review of sales records, she was Kleritec's best salesperson by a very large margin. She told us she did not use a written script, but instead relied on her memory. She is compensated at $50 per sale. She told us that her only paper contact with a consumer was to fax an inventory of what they had purchased. Ms. Cole terminated our call before it was completed and has not returned our subsequent calls. Her husband did later offer to provide documents, but he then also ceased responding.

B. Bank Accounts

Beginning February 3, 2016, we served the TRO/Asset Freeze on banks and other financial institutions where the Receivership Defendant was known to have accounts or credit card merchant accounts. The following accounts were frozen:

Account Name	Bank	Account No.	Balance Frozen
Telestar Consulting, Inc.	Bank of America	1007	$28,305.04
Telestar Consulting, Inc. dba Natureplay Art Company	Bank of America	1477	$52,803.05
Telestar Consulting, Inc. dba Kleritec and United Business Supply	Bank of America	8805	$907,577.20
Telestar Consulting, Inc.	Bank of America	5213	$18,798.93
Total			**$1,007,484.22**

Individual accounts of Mr. Angel have also been frozen, but are not presented here.

In addition to the money in these accounts, the Receivership Defendant has other substantial assets. *See* Section IV *infra*. The Bank of America accounts were transferred to the receivership to allow for the payment of numerous ongoing and necessary expenses to protect receivership assets.

C. Documents/Information/Electronic Data

Upon taking possession of the Sylmar office, we confirmed that hard copy documents onsite were secure and deployed the Receiver's computer forensic team to secure the electronic data and supervise the mirror imaging of servers and computer hard drives by FTC personnel. We also made arrangements with the three remote sales people as noted above.

D. Website

We have activated a receivership website, www.kleritecreceiver.com, to serve as a vehicle to communicate with consumers.

E. Cooperation

From the outset, Defendant Karl Angel and his counsel have been cooperative. As noted above at Section II(A), Mr. Angel was present at the immediate access, where his initial cooperation helped defuse the potential for disruptive behavior by employees. We have now met with Mr. Angel, his counsel, and selected employees on several occasions. Mr. Angel has responded to our substantive questions and shared his ideas for a compliant post-receivership business. While we have not always found his substantive defense of the company's practices credible, he and his counsel have nonetheless cooperated throughout the receivership process to date.

F. Compliance with TRO

After securing the premises and completing a basic review of the business, we addressed the issue of TRO compliance. We found that practices prohibited by the TRO, particularly the shipment of unordered merchandise, were commonplace. We could not, however, immediately quantify the number of transactions tainted by these and other unscrupulous practices or identify feasible compliance procedures to permit operations to continue until we had conducted a more thorough review. *See* Section V *infra* as to whether this business could be operated profitably and lawfully going forward.

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III.
SUMMARY OF OPERATIONS

The premise of this business is innocent enough – telephone sales of eco-friendly arts and crafts supplies and anti-microbial products. But, implementation of that premise incorporated unlawful tactics prohibited by consumer protection statutes as alleged by the FTC. The business model was based on a sales continuum – an initial sale (secured by a telephone cold call and priced at a discount) followed by reorders (frequently unauthorized or improperly authorized, and almost always priced much higher) – and inadequate or misleading disclosure as to the details of the transaction. When consumers resisted payment, sought to return unauthorized shipments, or sought clarification on transaction details, they were subjected to an aggressive collections department and cumbersome return authorization procedures. The tough reorder consumer complaints were escalated for handling directly to Mr. Angel, who orchestrated the timing and pricing of the reorders.

A. Product Lines

Telestar presently offers three product lines under the Kleritec dba: Arts & Crafts; Medistaph; and WIC.[1]

1. <u>Arts & Crafts (NaturePlay)</u>

The primary product line is a collection of arts and crafts materials marketed to preschools and daycare centers, presently under the brand name NaturePlay Art Company ("NaturePlay"). The products are generally sold in pre-packed standard boxes that contain an assortment of supplies one would expect to find in a daycare setting, including markers, paints, craft items, pencils, scissors, glue, tape, construction paper, scissors, and play dough. *See* Appendix, Vol. I, Exhibit 2 for product descriptions and pricing. For initial orders, products were sold in

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[1] In past incarnations, Kleritec also sold printer toner. We understand it still receives limited orders, but now processes them through a third party.

discounted "Value Packs," generally priced at $298, which Mr. Angel advised was roughly three times cost. Reorder Value Packs were priced as high as $798, roughly eight times cost.

The products are manufactured primarily by vendors in China. The FTC action does not challenge the products or their quality, just the telemarketing sales tactics deployed to sell them.

In 2015, NaturePlay gross sales were approximately $4 million, representing approximately 57% of Kleritec gross sales. Upon our arrival, the warehouse was stacked with NaturePlay inventory. For further details on sales and inventory, *see* Section IV *infra*.

2. <u>Medistaph</u>

The Medistaph line is comprised of an anti-microbial skin wipe, blood removal spray, and a broad spectrum disinfectant marketed primarily to high school and collegiate sports programs, but also to police and fire departments, beauty salons, and veterinary clinics. *See* Appendix, Vol. I, Exhibit 3 for product descriptions and pricing. Some Arts & Crafts Value Packs included Medistaph products. The FTC action also does not challenge these products or their quality, just the telemarketing sales tactics deployed to sell them. In 2015, Medistaph gross sales were approximately $3 million, representing approximately 42% of Kleritec gross sales. Upon our arrival, the warehouse was well stocked with inventory. For further details on sales and inventory, *see* Section IV *infra*.

3. <u>WIC</u>

Women, Infant, and Children ("WIC") is a federal program of grants to the states to support expectant and recent mothers and their young children. The products include sippy cups, soft spoons, "hot" spoons, and toothbrushes. *See* Appendix, Vol. I, Exhibit 4 for product descriptions and pricing. WIC sales have been modest, generally below $100,000 annually. These sales have been managed by a part-time employee, selling to a customer base that had dwindled to approximately 200, approximately 100-150 of which were active within Kleritec. Unlike the other product lines, we found no evidence of consumer complaints, returns, or "refused deliveries" relating to WIC. The one-person sales staff did regularly secure reorders by asking consumers when they expected to need more stock and would like a call back (e.g., six months, eight months), and on rare occasions cross-marketed other Kleritec products. There did not appear to be any problems with the WIC reorder process.

B. Initial Sales

Kleritec (and its predecessor companies) has built a large customer database through the purchase of customer lists and an old-fashioned sales technique – cold calls to businesses identified in publicly-available directories. The primary targets have been licensed daycare centers (NaturePlay), school athletic departments and police and fire departments (Medistaph). Initially, the "front" salespeople were provided lists of potential sales targets, broken down by state, from which they started cold calling. The closure rate appears to have been low – the sales board in the sales room showed most "front" salespeople generating 1-4 sales over the course of an entire day (eight hours) of cold calling.[2]

After a salesperson confirmed the sale, the transaction was placed in an electronic queue at the one-person verification department with a protocol that no orders were to be shipped until they were verified. The verification scripts we located did not include full details about product and price, but were aimed primarily at confirming the shipping address, spelling of the consumer's name and the Net 30 terms. (*See*, Appendix, Vol. I, Exhibit 5.) Once the sale was so "verified," it was electronically added to the shipping department's active orders for immediate shipping.

[2] The exception is the single independent contractor cold caller in Florida, who apparently used advertising and her own techniques to generate much higher sales numbers. We do not have enough transparency into her operations to understand why she had such dramatically higher sales.

We have seen some onsite examples of consumer complaints about prohibited practices in these initial sales, although it appears these were not overtly management-driven, but rather the natural by-product of the culture – *i.e.*, the result of commissioned sales reps incentivized to sell with limited supervision. The basic facts we uncovered are as follows:

- Salespersons were incentivized to sell with an hourly wage, plus a $25 bonus for each order. (*See* Appendix, Vol. I, Exhibit 6.)
- The initial pitch focused on discounted pricing. (*See* Appendix, Vol. I, Exhibit 7.)
- Some consumers complained that the full cost of the order was not always fully disclosed during initial sales calls, the most recurring omission being the costs of freight and insurance. (*See* Appendix, Vol. I, Exhibit 8.)
- Some orders were described by salespeople as "no charge" samples or "try-out" promotions, but then the customer was invoiced. (*See* Appendix, Vol. I, Exhibit 9.)
- We did see some internal efforts to control sales personnel (Appendix, Vol. I, Exhibit 10), but the supervision did not appear to be adequately systemic or consistent.
- We did not see consistent procedures to insure that consumers agreed in advance to the specific product they were buying and to all terms of the sale. One salesperson was actually criticized by the titular sales manager for being too quick to send emails to customers listing exactly what would be shipped to them. (*See* Appendix, Vol. I, Exhibit 11.) This failure to confirm sale details prior to shipment created ambiguity and this lack of clear disclosure set the stage for unauthorized reorders that were often described as "back orders" of the initial order.

C. Reorders

Our investigation indicates that reorder sales abuses were intentional and key elements of the Kleritec sales strategy – to a large extent, front sales were low-priced teasers for the higher-priced (regularly unauthorized) reorders to follow. For both NaturePlay and Medistaph, reorder sales volume far exceeded front sales volume, largely attributed to reorder pricing that was 2-3 times the initial order (or more). (*See* Section IV *infra*.)

The internal reorder protocol was simple: after a consumer paid the invoice for a front sale, that consumer's file was placed in a reorder queue on the second floor of the office, allowed to "age" two to four months, and then activated for a reorder sales call to be made by one of three reorder salesmen, the primary one being Mr. Angel. Reorders were exempted from the verification procedures applied to front sales on the theory that the reorder call itself was a form of verification.

We found ample evidence of unauthorized shipments and a reorder sales process rife with omissions and sometimes outright lies:

- Consumers complained they were shipped goods without placing an order. (*See* Appendix, Vol. I, Exhibit 12.)
- Consumers complained they were told they were receiving a no charge back-order, but were later invoiced with pricing much higher than the initial order. (*See* Appendix, Vol. I, Exhibit 13.)
- Some consumers complained they received product even after expressly telling the Kleritec representative not to ship. (*See* Appendix, Vol. I, Exhibit 14.)
- Even consumers who did not object to the back order complained that they were not informed up front the pricing was much higher than the initial order. (*See* Appendix, Vol. I, Exhibit 15.)

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D. Customer Service

There was not a bright line between the customer service and collections departments, but the customer service aspect focused on the fielding and attempted "resolution" of billing complaints and requests to return product:

- Reorder-related customer service and billing complaints from the bigger customers were escalated to Mr. Angel for handling. He often defused these by granting discounts. He often identified himself as Karl in the shipping department. (*See* Appendix, Vol. I, Exhibit 16.)
- Consumers seeking return authorizations were subjected to a complex bureaucracy of which they had no forewarning. Authorizations were denied if all procedures were not followed. Some returns that arrived at Kleritec without the formal return authorization were refused and sent back to the consumer, such that the consumer would be stuck with the product and the freight cost of the rejected return. (*See* Appendix, Vol. I, Exhibit 17.)

E. Collections

Some of the techniques and tactics deployed by the Collections Department were very aggressive and perhaps unlawful:

- Some consumers were sent letters via FedEx from "Telestar Loss Prevention" that an internal investigation had commenced and threatening to contact the local authorities and state licensing agencies and report an "Online Fraud Warning Alert", concluding in bright red letters, "[i]f we do not hear from you within 48 hours, we will concluded [sic] that this is a criminal matter." (*See* Appendix, Vol. I, Exhibit 18.)
- Consumers were also sent letters from "Tracers Investigations Ltd" entitled "Preparation for Court Summons," notifying them they were "under investigation "for willfully refusing to respond to repeated

notices of debt owed." Tracers was not, however, a third-party collector, but the dba once used by a Kleritec employee who was a licensed private investigator. (*See* Appendix, Vol. I, Exhibit 19.)

- We also saw on site a "Tracers Investigation Collection Script" which included the threat to report consumers to the state licensing board and Better Business Bureau. The script included a note that if the consumer asked about the company, the appropriate response was to state "[t]his case # refers to Kleritec vs. [their day care center name]." (*See* Appendix, Vol. I, Exhibit 20.)

F. Complaints

In an effort to roughly gauge the percentage of transactions impacted by prohibited practices, we pulled and reviewed consumer email traffic coming into info@kleritec.com for the period January 1, 2016 through February 4, 2016.[3] After excluding emails that related to internal administrative matters, this traffic totaled 224 emails from consumers – 144 of these were complaints or requests for return authorizations.

These 144 emails are contained in Appendix, Vol. II, filed with this Preliminary Report. We appreciate that this is a voluminous submission, but believe it provides a telling snapshot of Kleritec operations and sales practices.[4] While we cannot confirm the statistical significance of these complaints in relation

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[3] Customer invoices listed an 800 telephone number front and center; the info@kleritec.com was also on the invoice, but not prominently displayed. This seemed to result in initial customer complaints going to the 800 number. The email contact often occurred after the calls were not returned or the complaint was unresolved.

[4] Mr. Angel, based on his review of the FTC filing, concedes there was a problem with reorders. However, in meetings with us, he has stressed that many of the consumer complaints are not supportable. He also did present some specific instances, including those involving FTC declarants, in which he believed the consumer complaint was factually incorrect and not warranted. However, even crediting Mr. Angel's position that some of the complaints are unwarranted, the enormity of the email complaints and their consistency with the FTC allegations is compelling evidence that the prohibited sales practices were routinely occurring.

to the full universe of Kleritec transactions, they substantiate a significant problem – roughly 144 consumer complaints in a one-month period. Notably, these complaints identified unscrupulous sales practices similar to those alleged by the FTC. For example:

- "We have had nothing but issues with orders not being filled, and if they are, they are not at the original quoted price. Product is sent without our approval, and orders cannot be cancelled. . . ." – Fran King, January 13, 2016. (*See* Appendix, Vol. II, page 52.)
- "We do not wish to receive ANYTHING from your company as the phone call was very misleading . . . . I was told that [Kleritec] wanted me to be satisfied with the items and that if I felt after reviewing the content list that if it was not what I was expecting that I should keep the items because it cost more for them to be returned. . . ." – Teresa Sue Rodgers, January 14, 2016. (*See* Appendix, Vol. II, pages 59-63.)
- "We have just received a shipment that we already indicated we did not want. . . . **We do not want any more deliveries of such product. We are not interested in this product, we do not want this product and we will take action if more are sent.**" – April Barker, January 19, 2016 (emphasis in original). (*See* Appendix, Vol. II, page 82.)
- "I just got a call from Carl in shipping telling me we have more of these towelettes to be delivered, but I was told with our last shipment, over a year ago, that we have completed the order and we have completely paid for this all, and this whole order is complete and final. Why am I now getting a call saying that there is more to be delivered (and I'm sure charged for)?" – Ehren Mertz, January 20, 2016. (*See* Appendix, Vol. II, page 95.)

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IV.

FINANCIAL INFORMATION

We have conferred with the Receivership Defendant's accountant, reviewed prior tax returns and QuickBooks accounting records for 2010-2015. Appendix, Vol. I, Exhibit 21 is the financial summary prepared by the Receiver's forensic accountant, the Kaseno CPA Firm. We must caution that we have not conducted an audit of Defendants' records. Given inconsistencies between tax returns and QuickBooks and some idiosyncrasies in financial recordkeeping, we also cannot vouch for the specific details of the available financial records. But, we can summarize the general parameters of the company's financial results.

A. Sales and Profitability

Telestar has historically been a profitable business with annual sales of $4-5 million and gross margins (after deducting the costs of goods sold) in excess of 50%. Based on the company's tax returns for the period 2010-2014, total annual sales have ranged from a low of $4.3 million in 2012 to a high of $5.3 million in 2014, with gross profits in those years ranging from a low of $2.6 million in 2012 to a high of $3.6 million in 2014. General and administrative expenses have impacted profitability with net income reported in the tax returns for 2010-2014 ranging from a low of $36,341 in 2010 to a high of $276,356 in 2014.

For 2015, QuickBooks indicates sales of $5 million, gross profit of $3.3 million and net income of $450,000, but we cannot verify the accuracy of these numbers, which have not been reviewed and/or adjusted for tax return purposes.

For 2015, we also sought sales information from the internal SalesPad system, looking for some useful breakdown of sales by product line and by type (initial orders vs. reorders).[5] Given the absence of a 2015 tax return and the

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[5] Kleritec's General Manager ran a sales report by sales representative for 2015 and color coded those sales by Medistaph First Time Sales ($352,883), Medistaph Repeat Sales ($2,654,858), Arts & Crafts First Time Sales

internal idiosyncrasies of these sales reports and QuickBooks, we cannot confirm precise calculations, but these reports confirm the theme – this business thrived and survived on reorders. These reports indicate that reorders (approximately $5.5 million) accounted for roughly 75% of total gross sales of approximately $7.2 million. For 2015, gross sales of Medistaph were approximately $3 million ($352,884 initial sales; $2.6 million reorders) and for NaturePlay approximately $4 million ($1.1 million initial sales; $2.9 million reorders). Against those gross sales, returns and other adjustments were approximately $1.5 million. Unfortunately, the reports now available to us do not provide a reliable basis to allocate these returns between initial sales and reorders, but the records onsite certainly indicate that most returns and adjustments were reorder-related.

B. Inventory

As noted above, the warehouse is maxed out with NaturePlay and Medistaph inventory, all fully paid for. *See* Appendix, Vol. I, Exhibit 1. Since product quality is not at issue in the FTC's action, this paid-for inventory presents a significant opportunity if it can be sold through compliant sales practices. The potential market value is in the millions of dollars, but cannot be estimated with precision as that value will be driven by the sales channels deployed (telemarketing, wholesale to retail stores, or web store), pricing, and the extent to which sales and the brands themselves are diluted by ongoing litigation. Mr.

($1,149,749), Arts & Crafts Reorders ($2,923,797), Miscellaneous ($184,024), and Returns/Uncollectable/Write-Offs ($1,542,506). That translates to total gross sales of $7.2 million and total net sales of $5.7 million. Staff personnel also ran reports for 2015 Front Sales Without Freight ($1.2 million) and 2015 Reorder Sales Without Freight ($4.5 million) for a total net sales (without freight) of $5.7 million.

We cannot reconcile the specific differences between these two reports and the current QuickBooks results (with sales of $5 million), except to note that some of the variation may be due to whether freight charges are included. For our purposes here, however, we need not resolve those discrepancies – these sales figures all confirm the basic reality that the business was very dependent on reorders.

Angel has reported his view that the NaturePlay and Medistaph "brands" may have enterprise values well above that.

One factor is reasonably certain - this inventory would have minimal liquidation value.

C. Accounts Receivables

We ran the aging report as of February 19, 2016 which breaks down receivables as follows:

41-60 days: $438,108
61-90 days: $205,589
91-120 days: $370,273
121-150 days: $188,312
151 days and over: $1,530,287
Total: $2,682,571

Many of these may be stale and uncollectible, but these accounts receivable nonetheless represent an asset of the receivership. As described in Section V(B)(2), the Receiver's challenge will be to implement a process to separate tainted from non-tainted receivables and implement a fully compliant collection process as to untainted sales.

D. Other Receivership Property

The other significant asset of the business is the real property asset of the three suites owned in the Sylmar building, purchased in 2010 for $1.9 million and not presently encumbered by any debt.

We did identify a Rolls Royce automobile which Mr. Angel leased and used, but which was funded by the company with total sunk costs in lease expenses totaling nearly $180,000 over the last two years. Mr. Angel has indicated there is no actual equity and he has arranged with the dealer to shift the lease to a third party. He has not yet provided documentation in support of his claim of no equity.

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Mr. Angel has reported his view that the NaturePlay and Medistaph brands may have equity unto themselves as brands, but any such value is aspirational and not quantifiable for purposes of this receivership.

V.

CAN THE BUSINESSES BE OPERATED LAWFULLY AND PROFITABLY?

Section XI(N), at page 19, of the TRO authorizes the Receiver to continue the business of the Receivership Defendant, but with a significant proviso – "provided, however, that the continuation and conduct of the business shall be conditioned upon the Receiver's good faith determination that the businesses can be lawfully operated at a profit using the assets of the receivership estate."

In this case, fair resolution of the lawful/profitable issue requires careful analysis, but the business could, in theory, be operated both lawfully and profitably, subject to multiple qualifiers.

The products themselves are innocent and their quality is not the subject of the FTC's claims. The warehouse is literally packed with paid for and ready-to-ship inventory. These are not contraband products. They could be lawfully sold through a variety of sales strategies, telemarketing, or otherwise. The business could also, in theory, operate profitably, but only if Defendants and the FTC can reach a court-ordered consent arrangement whereby operations could be financed.

A. What Does the TRO Prohibit?

Our start point for this analysis is the TRO itself and a break out of the prohibited practices. In a nutshell, the TRO (Section I, pages 7-9), prohibits: (i) shipment of unordered merchandise, sending bills or requesting payment for unordered merchandise; (ii) misrepresentations that the consumer ordered or agreed to pay for goods shipped by Defendants, that Defendants are shipping a "backorder", that consumers have agreed to pay for multiple shipments, or any other material facts as to consumer's decision to purchase; (iii) failure to disclose the total amount of charges, the quantity of materials the consumer will receive, and all material restrictions and conditions of the sale; (iv) false and misleading statements in telephone call to induce retail sale of nondurable office or cleaning supplies, including misrepresentations that consumer ordered or agreed to purchase goods or was obligated to pay; (v) failure to disclose in clear and conspicuous manner before consumer consents to sale the total costs to purchase, receive or use, the quantity and all material restrictions to receive or use the goods.

As to collection of accounts, the TRO prohibits Defendants from attempting to collect payment from consumers directly or through any collection agency (Section II) and prohibits the Receiver (Section XI(B)) from attempting to collect or receive any amount from a consumer if the Receiver believes the consumer was a victim of the unlawful conduct alleged in the Complaint.

B. Lawful

While telemarketing sales practices prohibited by the TRO are ingrained in portions of the business (particularly unauthorized reorders), compliant and lawful sales practices could theoretically be implemented such that the business could resume, subject to multiple qualifiers. Such a compliant business, if achievable, would also represent a potential vehicle for preserving assets by converting the current inventory to sales.

1. <u>Sales – Front Sales and Reorders</u>

We have seen some instances of non-compliant sales tactics for front sales by over-zealous sales reps incentivized to sell with limited supervision on the sales floor. Such improper front-end sales tactics could be removed with training, tight scripts, and vigilant supervision, and we do not view them as ingrained in the business' operations. In comparison, reorders are the core of the current business and a high level of reorder abuse has become ingrained in the sales operations as an element of management's business plan. But, even as to reorders, unlawful tactics could also be removed with training, tight scripts, and tight supervision.

The consideration of a complex plan to relaunch telemarketing sales – front and reorders – is not, however, necessary. Defendants have advised that they are prepared to terminate telemarketing sales to consumers in favor of an entire new business plan to sell their products under the NaturePlay and Medistaph brands through two sales channels – wholesale sales to big box retailers and sales to consumers through a web-store.

According to Mr. Angel, such a transition has been the company's end game for some time, but had been delayed due to technical setbacks in bringing the website to full functionality to process direct internet orders. If such a transition could be achieved, and financing were available for a restart, it would render moot the analysis of lawfulness of the current telemarketing because the telemarketing sales model would be abandoned. We must, however, leave to the Defendants, the FTC, and the Court whether such a revamped business could be incorporated in a consent decree or other order.

2. <u>Collections</u>

As a first step, we still face the challenge of implementing protocols for the processing of payments on hand at the Kleritec offices, but not yet deposited. We have presented a proposed process to the FTC and defense counsel for these on-hand payments. The challenge is to develop and implement a process to exclude the acceptance of consumer funds related to transactions tainted by the acts prohibited in the TRO. We have confirmed procedures whereby payments will be vetted such that no payments will be accepted if the Receiver has reason to believe the consumer was the victim of the unlawful conduct alleged in the FTC's Complaint. We intend to propose a process to evaluate accounts receivable collections to the parties after we have completed the on-hand payment review.

C. Profitable

The financial underpinnings of the Kleritec business are substantial – sellable product line; paid-for inventory; no debt; a debt-free warehouse office; and an owner with capital to invest in the business. The business has been profitable in the past with telemarketing sales, but those profits were fueled in sizeable part by reorder abuse and inadequate disclosures.

Whether Mr. Angel's vision of Kleritec 2.0 (with telemarketing sales replaced by wholesale sales to retailers and direct internet sales to consumers) could be profitable is uncertain. It would require additional capital, pose entrepreneurial risks beyond the scope of the receivership, and would likely necessitate a consent arrangement between the Defendants and the FTC, approved by the Court.

Dated: March 10, 2016 By: S/ Thomas W. McNamara
Thomas W. McNamara
Receiver

CERTIFICATE OF SERVICE

I hereby certify that on March 10, 2016, I caused the foregoing to be electronically filed with the Clerk of the Court using the CM/ECF system, which will send notification of the filing to all participants in the case who are registered CM/ECF users.

S/ Andrew W. Robertson
Andrew W. Robertson