

# PFSWEB INC

## **FORM 10-K** (Annual Report)

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**Form 10-K**

- ☒ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)**  
**OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the fiscal year ended December 31, 2004  
or  
☐ **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 000-28275

**PFSWEB, INC.**

*(Exact name of registrant as specified in its charter)*

Delaware  
*(State or other jurisdiction of  
incorporation or organization)*  
500 North Central Expressway, Plano, Texas  
*(Address of principal executive offices)*

75-2837058  
*(I.R.S. Employer  
Identification Number)*  
75074  
*(Zip code)*

Registrant's telephone number, including area code:  
972-881-2900

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

Securities registered pursuant to Section 12(g) of the Act:  
Common Stock, par value \$.001 per share

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

Indicate by a check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes ☐ No ☒

Indicate by a check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. Yes ☒ No ☐

The aggregate market value of the voting stock held by non-affiliates of the registrant as of June 30, 2004 (based on the closing price as reported by the National Association of Securities Dealers Automated Quotation System) was \$28,916,890.

As of February 28, 2005, there were 22,247,891 shares of the registrant's Common Stock, \$.001 par value, outstanding, excluding 86,300 shares of common stock in treasury.

**DOCUMENTS INCORPORATED BY REFERENCE**

The information required by Part III of this Annual Report, to the extent not set forth herein, is incorporated herein by reference from the registrant's definitive proxy statement relating to the annual meeting of stockholders, which definitive proxy statement shall be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year to which this Annual Report relates.

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*Unless otherwise indicated, all references to “PFSweb,” “the Company,” “we,” “us” and “our” refer to PFSweb, Inc., a Delaware corporation, and its subsidiaries. All references to “Daisytek” refer to our former parent corporation, Daisytek International Corporation, a Delaware corporation, and its subsidiaries. In June 2001, we elected to change our fiscal year end date from March 31 to December 31.*

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## **PART I**

### **Item 1. Business**

#### **General**

PFSweb is a leading provider of outsourcing and supply chain solutions. PFSweb's service breadth includes logistics and fulfillment, freight and transportation management, real-time order management, kitting and assembly, customer care (CRM), facility operations and management, web-commerce design and hosting, payment processing and financial services and more. Collectively, we define our offering as Business Process Outsourcing because we extend our clients infrastructure and technology capabilities, addressing an entire business transaction cycle from demand generation to product delivery. Our solutions support both business-to-business ("B2B") and business-to-consumer ("B2C") segments of the supply chain.

PFSweb serves as the "brand behind the brand" for companies seeking to increase their supply chain efficiencies. As a business process outsourcer, we offer scalable and cost-effective solutions for manufacturers, distributors, retailers and direct marketing organizations across a wide range of industry segments, from consumer goods to aviation. We provide our clients with seamless and transparent solutions to support their business strategies, allowing them to focus on their core competencies. Leveraging PFSweb's technology, expertise and proven methodology, we enable client organizations to develop and deploy new products, and implement new business strategies or address new distribution channels rapidly and efficiently through our optimized solutions. Our clients engage us both as a consulting partner to assist them in the design of a business solution as well as a virtual and physical infrastructure partner providing the mission critical operations required to build and manage that business solution. Together, we not only help our clients define new ways of doing business, but also provide them the technology, physical infrastructure and professional resources necessary to quickly implement this new business model. We allow our clients to quickly and dramatically change how they 'go-to-market.'

Each client has a unique business model and unique strategic objectives that require highly customized solutions. PFSweb supports clients in a wide array of industries including technology products, consumer goods, aviation, collectibles, food and beverage, apparel and home furnishings. These clients turn to PFSweb for help in addressing a variety of business issues that include customer satisfaction and retention, time-definite logistics, vendor managed inventory and integration, supply chain compression, cost model realignments, transportation management and international expansion, among others. We also act as a constructive agent of change, providing clients the ability to alter their current distribution model, establish direct relationships with end-customers, and reduce the overall time and costs associated with existing distribution channel strategies. Our clients are seeking solutions that will provide them with dynamic supply chain and channel marketing efficiencies, while ultimately delivering a world-class customer service experience.

Our technology and business infrastructure offering is flexible, reliable and fully scalable. This flexibility allows us to design custom, variable cost solutions to fit the business requirements of our clients' strategies. We earn revenue from two distinct business segments, yet operationally similar business models:

- First, we earn service fee revenues from charges to process individual business transactions on our clients behalf through our technology and infrastructure capabilities. These business transactions may include the answering of a phone call or an e-mail, the design and hosting of a client web-site, the receipt and storage of a client's inventory, the kitting and assembly of products to meet a client's customer's specifications, the shipping of products to our client's customer base, the management of a complex set of electronic data transactions designed to keep our client's suppliers and customers accounting records in balance, or the processing of a returned package. In the service fee revenue business segment, we do not own the inventory or the resulting accounts receivable, but provide management services for these client-owned assets.
- Secondly, we earn product revenue through our master distributor relationship with certain clients. In the product revenue business segment, we purchase inventory and upon sale of the product, own the accounts receivable.

Our capabilities are expansive. To offer the most necessary and resourceful solutions to our clients, we are

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continually developing capabilities to meet the pressing business issues in the marketplace. Our business objective is to focus on “Leading the Evolution of Outsourcing.” As our tagline suggests, we will continue to evolve our service offering to meet the needs of the marketplace and the demands of unique client requirements. We are most successful when we develop a new capability to enable a client to pursue a new initiative and we are then able to leverage that revolutionary development across other client or prospect solutions, as it becomes “best practice” in the marketplace. Our team of experts design and build diverse solutions for Fortune 1000, Global 2000 and major brand name clients around a flexible core of technology and physical infrastructure that includes:

- Technology collaboration provided by our suite of technology services, called the Entente Suite(SM), that are e-commerce and collaboration services that enable buyers and suppliers to fully automate their business transactions within their supply chain. Entente supports industry standard collaboration techniques including XML based protocols such as Biztalk and RosettaNet, real-time application interfaces, text file exchanges via secured FTP, and traditional electronic data interchange (“EDI”);
- Managed hosting and Internet application development services, including web site design, creation, integration and ongoing maintenance, support and enhancement of web site;
- Order management, including order processing from any source of entry, back order processing and future order processing, tracking and tracing, credit management, electronic payment processing, calculation and collection of sales tax and VAT, comprehensive freight calculation and email notification, all with multiple currency and language options;
- Customer Relationship Management (“CRM”), including interactive voice response (“IVR”) technology and web-enabled customer contact services through world-class call centers utilizing voice, e-mail, voice over internet protocol (“VOIP”) and internet chat communications that are fully integrated with real-time systems and historical data archives to provide complete customer lifecycle management;
- International fulfillment and distribution services, including warehouse management, inventory management, vendor managed inventory, inventory postponement, product warehousing, order picking and packing, freight and transportation management and reverse logistics;
- Facility Operations and Management (FOM) that includes process reengineering, facility design and engineering and employee administration;
- Kitting and assembly services, including light assembly, procurement services, Supplier Relationship Management, specialized kitting, and supplier consigned inventory hub in PFSweb’s distribution facilities or co-located in other facilities;
- Information management, including real-time data interfaces, data exchange services and data mining;
- Financial services, including secure on-line credit card processing related services, fraud protection, invoicing, credit management and collection, and working capital solutions; and
- Professional consulting services, including a consultative team of experts that customize solutions to each client and continuously seek out ways to increase efficiencies and produce benefits for the client.

We are headquartered in Plano, Texas where our executive and administrative offices are located as well as our primary technology laboratories and hosting facilities. We operate state-of-the-art call centers from our U.S. facilities located in Plano, Texas, and Memphis, Tennessee, and from our international facility located in Liege, Belgium. We have more than 1.6 million square feet of warehouse space in our leased and managed facilities in Memphis, TN, Southaven, MS, Grapevine, TX, Toronto, Canada and Liege, Belgium allowing us to provide global distribution solutions. The majority of these distribution facilities are highly automated and contain state of the art material handling and communications equipment. We provide solutions to clients that are often regarded as market leaders in a variety of different industries.

### Industry Overview

Business activities in the public and private sectors continue to operate in an environment of rapid technological advancement, increasing competition and continuous pressure to improve operating and supply chain efficiency while decreasing costs. We currently see the following trends within the industry:

- Manufacturers strive to restructure their supply chains to maximize efficiency and reduce costs in both B2B and B2C markets and to create a variable-cost supply chain able to support the multiple unique needs of each of their initiatives, including traditional and electronic commerce.
- Government agencies are increasingly focused on improved citizen usability and interaction, as well as the need to manage government initiatives from an efficiency perspective. With revisions to the United States Government's Competitive Sourcing Program (A-76), the government is mandated to obtain commercially available goods and services from the private sector when it makes economic sense to do so.
- Companies in a variety of industries seek outsourcing as a method to address one or more business functions that are not within their core business competencies, to reduce operating costs or to improve the speed or cost of implementation.

### Supply Chain Management Trend

As companies maintain focus on improving their businesses and balance sheet financial ratios, significant efforts and investments continue to be made identifying ways to maximize supply chain efficiency and extend supply chain processes. Working capital financing, vendor managed inventory, supply chain visibility software solutions, distribution channel skipping, direct to consumer e-commerce sales initiatives, and complex upstream supply chain collaborative technology are products that manufacturers seek to help them achieve greater supply chain efficiency.

A key business challenge facing many manufacturers and retailers as they evaluate their supply chain efficiency is in determining how the trend toward increased direct-to-consumer business activity will impact their traditional B2B and B2C commerce business models. Order management and small package fulfillment and distribution capabilities are becoming increasingly important processes as this trend evolves. We believe manufacturers will look to outsource their non-core competency functions to support this modified business model. Forrester Research reports US online retail sales will more than double over the next six years, reaching \$316 billion by 2010. They attribute this growth to the growing population for online shopping households, combined with effective multi-channel integration and site improvements from retailers. We believe that companies will continue to strategically plan for the impact that e-commerce and other new technology advancements will have on their traditional commerce business models and their existing technology and infrastructure capabilities.

Manufacturers, as buyers of materials, are also imposing new business practices and policies on their supplier partners in order to shift the normal supply chain costs and risks associated with inventory ownership away from their own balance sheets. Through techniques like Vendor Managed Inventory ("VMI") or Consigned Inventory Programs ("CIP"), manufacturers are asking their suppliers, as a part of the supplier selection process, to provide capabilities where the manufacturer need not own, or even possess, inventory prior to the exact moment that unit of inventory is required as a raw material component or for shipping to a customer. To be successful for all parties, business models such as these often require a sophisticated collection of technological capabilities that allow for complete integration and collaboration of the information technology environments of both the buyer and supplier. For example, for an inventory unit to arrive at the precise required moment in the manufacturing facility, it is necessary for the Manufacturing Resource Planning ("MRP") systems of the manufacturer to integrate with the CRM systems of the supplier. When hundreds of supplier partners are involved, this process can become quite complex and technologically challenging. Buyers and suppliers are seeking solutions that utilize XML based protocols like Biztalk, RosettaNet and other traditional EDI standards in order to ensure an open systems platform

that promotes easier technology integration in these collaborative solutions.

### Government Outsourcing Trend

In 2001, a task force was launched to identify priority actions to achieve strategic improvements in government and set in motion a transformation of government around citizens' needs. The federal government formulated an E-Government strategy in 2002, which was created to support multi-agency projects that improve citizen services and yield performance gains. Also, government mandate A-76 states that Government agencies must conduct thorough audits to determine the lowest cost and most efficient method of doing business, and to outsource to the public sector when in-house operations are unable to compete.

As stated in the February 2002 E-Government Strategy document developed by the U.S. Office of Management and Budget (OMB) E-Government task force, the primary goals for this initiative are to:

- Make it easy for citizens to obtain service and interact with the federal government;
- Improve government efficiency and effectiveness; and
- Improve the government's responsiveness to citizens.

According to the E-Government Strategy document for fiscal year 2006, the federal government's investment in information technology (IT) is estimated to be \$65 billion. The continued investment made in IT spending provides opportunities for the government to continue to transform itself into a citizen-centered E-Government and provide additional opportunities for the government to work with the private sector to develop more user friendly methods of interaction. Past agency-centered IT approaches have limited the government's productivity gains and ability to serve citizens.

In addition to the E-government strategy, the Administration announced its intentions to open commercial activities performed by the government to the dynamics of competition between the public and private sectors, known as Competitive Sourcing. According to "Competitive Sourcing, Conducting Public-Private Competition in a Reasoned and Responsible Manner; Executive Office of the President OMB" July 2004, the OMB estimates that approximately 26% of the 1.6 million workforce from government agencies are engaged in commercial activities that should be available for competition. Activities that fall into the Competitive Sourcing agenda include data center services, information technology services, financial management and logistics.

Other opportunities within the government sector include Business Process Outsourcing initiatives. According to the U.S. Federal Government Business Process Outsourcing 2004-2008 Forecast by IDC, "BPO in general, and spare parts supply chain management in particular, is a growing opportunity within the federal government. Growth is expected to continue through 2008 and beyond, as more government agencies see the success for both the Defense Department and civilian BPO efforts."

Through the E-Government Strategy, Government agencies are currently faced with pressure to upgrade technology capabilities and to better interface with their audiences. Combined with the A-76 initiative that directs Government agencies to pursue the most cost-effective method of doing business, current federal strategy now enforces government's need to better understand public alternatives, submit to extensive requests for proposals to an array of government and non-government providers, and to perform complex evaluations of existing operations and functions. An ongoing requirement is to migrate the management of systems, data and business processes from multiple agencies to a joint solution, supported by one or two service providers. We believe these initiatives will continue to drive government usage of outside sources.

### Outsourcing Trend

In response to growing competitive pressures and technological innovations, we believe many companies, both large and small, are focusing their critical resources on the core competencies of their business and utilizing business process outsourcing to accelerate their business plans in a cost-effective manner and perform non-core business functions. Outsourcing provides many key benefits, including the ability to:



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- Enter new business markets or geographic areas rapidly;
- Increase flexibility to meet changing business conditions and demand for products and services;
- Enhance customer satisfaction and gain competitive advantage;
- Reduce capital and personnel investments and convert fixed investments to variable costs;
- Improve operating performance and efficiency; and
- Capitalize on skills, expertise and technology infrastructure that would otherwise be unavailable or expensive given the scale of the business.

As a result, the market for business process outsourcing services continues to grow. IDC predicts that the worldwide business process outsourcing market will reach \$682.5 billion in 2008, an 11% annual increase from the estimated \$405.1 spent in 2003. They further predict the U.S. BPO market, accounting for approximately 60% of the worldwide market, is expected to increase to \$392.7 billion in 2008 from \$241.3 billion in 2003.

According to IDC's Worldwide and U.S. Business Process Outsourcing Forecast, the market has gone through profound changes in recent years that have forced companies to reevaluate their business operations. Many companies have begun to "explore and evaluate the applicability of BPO to their business operations and its role in helping them achieve the new goals they are thinking about. This process is causing unprecedented demand for BPO services across an ever-expanding list of business functions."

Typically, outsourcing service providers are focused on a single function, such as information technology, call center management, credit card processing, warehousing or package delivery. This focus creates several challenges for companies looking to outsource more than one of these functions, including the need to manage multiple outsourcing service providers, to share information with service providers and to integrate that information into their internal systems. Additionally, the delivery of these multiple services must be transparent to the customer and enable the client to maintain brand recognition and customer loyalty. According to IDC, the ability to provide a total package of services continues to be one of the key buying trends of BPO services. Furthermore, traditional commerce outsourcers are frequently providers of domestic-only services versus international solutions. As a result, companies requiring global solutions must establish additional relationships with other outsourcing parties.

Another vital point for major brand name companies seeking to outsource is the protection of their brand. When looking for an outsourcing partner to provide infrastructure solutions, brand name companies must find a company that can ensure the same quality performance and superior experience that their customers expect from their brands. Working with an outsourcing partner requires finding a partner that can maintain the consistency of their brand image, which is one of the most valuable intangible assets that recognized brand name companies possess.

## The PFSweb Solution

PFSweb serves as the "brand behind the brand" for companies seeking to increase the efficiencies of all aspects of their supply chain.

Our value proposition is to become an extension of our clients' businesses by delivering a superior experience that increases and enhances sales and market growth, customer satisfaction and customer retention. We act as both a virtual and a physical infrastructure for our clients' businesses. By utilizing our services, our clients are able to:

*Quickly Capitalize on Market Opportunities.* Our solutions empower clients to rapidly implement their supply chain and e-commerce strategies and to take advantage of opportunities without lengthy integration and implementation efforts. We have ready built technology and physical infrastructure that is flexible in its design, which facilitates quick integration and implementation. The PFSweb solution is designed to allow our clients to deliver consistent quality service as transaction volumes grow and also to handle daily and seasonal peak periods. Through our international locations, our clients can sell their products almost anywhere in the world.

*Improve the Customer Experience.* We enable our clients to provide their customers with a positive buying experience thereby maintaining and promoting brand loyalty. Through our use of advanced technology, we can respond directly to customer inquiries by e-mail, voice or data communication and assist them with on-line ordering and product information. We offer our clients a “world-class” level of service, including 24-hour, seven-day-a-week, Web-enabled customer care service centers, detailed CRM reporting and exceptional order accuracy. We have significant experience in the development of Internet web sites that allows us to recommend features and functions that are easily navigated and understood by our client’s customers. Our technology platform is designed to ensure high levels of reliability and fast response times for our clients’ customers. Because our technology is “world-class,” our clients benefit from being able to offer the latest in customer communication and response conveniences to their customers.

*Minimize Investment and Improve Operating Efficiencies.* One of the most significant benefits that outsourcing to PFSweb provides is the ability to transform fixed costs into variable costs. By eliminating the need to invest in a fixed capital infrastructure, our clients’ costs typically become directly correlated with volume increases or declines. Further, as volume increases drive the demand for greater infrastructure or capacity, PFSweb is able to quickly deploy additional resources. We provide services to multiple clients, which enables us to offer our clients economies of scale, and resulting cost efficiency, that they may not have been able to obtain on their own. Additionally, because of the large number of daily transactions we process, PFSweb has been able to justify investments in levels of automation, security surveillance, quality control processes and transportation carrier interfaces that are typically outside the scale of investment that our clients might be able to cost justify on their own. These additional capabilities can provide our clients the benefits of enhanced operating performance and efficiency, reduced inventory shrinkage, and expanded customer service options.

*Access a Sophisticated Technology Infrastructure.* We provide our clients with ready access to a sophisticated technology infrastructure through our Entente Suite, which is designed to interface seamlessly with their systems. We provide our clients with vital product and customer information that can be immediately available to them on their own systems or through web based graphic user interfaces for use in data mining, analyzing sales and marketing trends, monitoring inventory levels and performing other management functions.

### **The PFSweb Strategy**

In 2005, we continue to maintain a simple but effective strategy statement to drive our actions for the year, QGP. This acronym stands for Quality, Growth and Profit. We believe that if we can achieve outstanding performance on these three basic elements, they will provide for a stable foundation for the future of PFSweb. As the evolution of our business model continues, we will remain focused on these three fundamentals:

*Quality :* To exceed our client’s service level requirements and enhance the value of their “brand” while providing their customers a positive, memorable and efficient experience.

*Growth :* To increase our company’s revenue and gross profit from its current levels. To aggressively market simplified product messages to drive new clients and revenue and profit growth. To become a larger company and create career and additional employment opportunities. Embrace strategic partnering to accentuate strengths and minimize weaknesses.

*Profit:* To generate positive cash flow and continue to strive for consistent profitable results. To increase the value of our company for all of its stakeholders while rewarding our team members with challenging, fun and memorable life experiences.

The successful balance of the execution of these fundamental strategies over the next year is targeted to result in the formation of a solid strategic and financial foundation for PFSweb and provide PFSweb a sustainable and profitable business model for the future.

See “Risk Factors” for a complete discussion of risk factors related to our ability to achieve our objectives and fulfill our business strategies.

### PFSweb Services

We offer a comprehensive and integrated set of business infrastructure solutions that are tailored to our clients' specific needs and enable them to quickly and efficiently implement their supply chain strategies. Our services include:

*Technology Collaboration.* We have created the Entente Suite, which illustrates the level of electronic cooperation that is possible when we construct solutions with our clients using this technology service offering. This set of technology services enables everything from order processing and inventory reporting to total e-commerce design and implementation. The Entente Suite comprises four key services—EntenteWeb®, EntenteDirect®, EntenteMessage® and EntenteReport®.

EntenteWeb is a one-stop shop for the entire e-commerce process, particularly for companies with unusual needs or specific requests that are not easily met by the typical e-commerce development packages. EntenteWeb is a service utilizing our revolutionary GlobalMerchant Commerceware™ e-commerce software platform that is particularly focused to enable global commerce strategies with its extensive currency and language functionality. EntenteDirect provides clients with a real-time, user-friendly interface between their system and PFSweb order processing, warehouse management and related functions. Using real-time or batch processes, EntenteMessage is a file exchange service for clients using our warehousing and distribution facilities. EntenteReport is a reporting and inquiry service particularly suited to companies that need to put key e-commerce information into the hands of business users, but do not have the IT resources to facilitate the necessary data extraction, manipulation and presentation. EntenteReport consists of an industry-standard browser-based report writer and a client-customized data warehouse configuration.

The Entente Suite operates in an open systems environment and features the use of industry-standard XML, enabling customized e-commerce solutions with minimal changes to a client's systems or our Enterprise Resource Planning ("ERP") systems. The result is a faster implementation process. Additionally, by using XML, the Entente Suite offers companies a more robust electronic information transfer option than text file FTP or EDI, although the text file FTP, EDI and other transfer methods are still supported.

*EntenteWeb Managed Hosting and Internet Application Development.* Our EntenteWeb service provides a complete e-commerce website solution for our clients. We engage collaboratively with our clients to design, build, host, and manage fully branded, fully customized and fully integrated e-commerce web applications for B2C and B2B channels. As with all major brand name companies, consistency within the brand image is vital; therefore, our web designers create online stores that seamlessly integrate and mirror the exact brand image of our clients.

We offer a broad range of hosting and support plans that can be tailored to fit the needs of each client. Utilizing IBM's eServer xSeries servers, Microsoft's .NET Technologies and our proprietary GlobalMerchant Commerceware platform, we maintain a robust hosting environment for our hosted client web site properties. Additionally, our EntenteWeb service includes state-of-the-art web analytics via Web Trends OnDemand — Enterprise Edition. This highly advanced and flexible analytics tool delivers the critical e-business information that our clients need to maximize the effectiveness of their online store.

EntenteWeb is a complete front-to-back e-commerce service that incorporates components ranging from the look of the user interface to specific business purchasing, warehousing and shipping needs, enabling companies to define in exact terms their desired e-commerce site functionality.

*Order Management.* Our order management solutions provide clients with interfaces that allow for real-time information retrieval, including information on inventory, sales orders, shipments, delivery, purchase orders, warehouse receipts, customer history, accounts receivable and credit lines. These solutions are seamlessly integrated with our web-enabled customer contact centers, allowing for the processing of orders through shopping cart, phone, fax, mail, email, web chat, and other order receipt methods. As the information backbone for our total supply chain solution, order management services can be used on a stand alone basis or in conjunction with our other business infrastructure offerings, including customer contact, financial or distribution services. In addition, for the B2B market, our technology platform provides a variety of order receipt methods that facilitate commerce within various stages of the supply chain. Our systems provide the ability for both our clients and their customers to track the status

of orders at any time. Our services are transparent to our clients' customers and are seamlessly integrated with our clients' internal systems platforms and web sites. By synchronizing these activities, we can capture and provide critical customer information, including:

- Statistical measurements critical to creating a quality customer experience, containing real-time order status, order exceptions, back order tracking, allocation of product based on timing of online purchase and business rules, the ratio of customer inquiries to purchases, average order sizes and order response time;
- B2B supply chain management information critical to evaluating inventory positioning, for the purpose of reducing inventory turns, and assessing product flow through and end-consumer demand;
- Reverse logistics information including customer response and reason for the return or rotation of product and desired customer action;
- Detailed marketing information about what was sold and to whom it was sold, by location and preference; and
- Web traffic reporting showing the number of visits ("hits") received, areas visited, and products and information requested.

*Customer Relationship Management.* We offer a completely customized CRM solution for clients. Our CRM solution encompasses a full-scale customer contact management service offering, as well as a fully integrated customer analysis program. All customer contacts are captured and customer purchases are documented. Full-scale reporting on all customer transactions is available for evaluation purposes. Through each of our customer touch-points, information can be analyzed and processed for current or future use in business evaluation, product effectiveness and positioning, and supply chain planning.

An important feature of evolving commerce remains the ability for the customer to speak with a live customer service representative. Our experience has been that a majority of consumers tell us they visited the web location for information, but not all of those consumers chose to place their order online. Our customer care services utilize features that integrate voice, e-mail, standard mail, data and Internet chat communications to respond to and handle customer inquiries. Our customer care representatives answer various questions, acting as virtual representatives of our client's organization, regarding order status, shipping, billing, returns and product information and availability as well as a variety of other questions. For certain clients, we handle Level I and Level II technical support. Level I technical support involves assisting clients' customers with basic technical issues, i.e. computer application issues. Level II support may involve a more in-depth question and answer session with the customer. These customer care representatives are certified in the appropriate applications and have the ability to evaluate hardware, compatibility and software installation issues. Our web-enabled customer care technology identifies each customer contact automatically and routes it to the available customer care representative who is individually certified in the client's business and products. Our web-enabled customer care centers are designed so that our customer care representatives can handle several different clients and products in a shared environment, thereby creating economy of scale benefits for our clients as well as highly customized dedicated support models that provide the ultimate customer experience and brand reinforcement. Our advanced technology also enables our representatives to up-sell, cross-sell and inform customers of other products and sales opportunities. The web-enabled customer care center is fully integrated into the data management and order processing system, allowing full visibility into customer history and customer trends. Through this fully integrated system, we are able to provide a complete CRM solution.

With the need for efficiency and cost optimization for many of our clients, we have integrated IVR as another option for customer contacts. IVR creates an "electronic workforce" with virtual agents that can assist customers with vital information at any time of the day or night. IVR allows for our clients' customers to deal interactively with our system to handle basic customer inquiries, such as account balance, order status, shipment status, catalog requests, product and price inquiries, and routine order entry for established customers. The inclusion of IVR to our service offering allows us to offer a cost effective way to handle high volume, low complexity calls.

*International Fulfillment and Distribution Services.* An integral part of our business process outsourcing solutions is the warehousing and distribution of inventory either owned by our clients or owned by us through our

master distributor relationships. We currently have more than 1.6 million square feet of leased or managed warehouse space domestically and internationally to store and process our clients' inventory. We receive client inventory in our distribution centers, verify shipment accuracy, unpack and audit (a process that includes spot-checking a small percentage of the clients inventory to validate piece counts and check for damages that may have occurred during shipping, loading and unloading). Upon request, we inspect for other damages or defects, which may include checking fabric, stitching and zippers for soft goods, or 'testing' power-up capabilities for electronic items. We generally stock for sale within one business day of unloading. On behalf of our clients, we pick, pack and ship their customer orders and can provide customized packaging, inserts and promotional literature for distribution with customer orders.

Our distribution facilities contain computerized sortation equipment, highly mobile pick-to-light carts, powered material handling equipment, scanning and bar-coding systems and automated conveyors, in-line scales and x-ray equipment used to inspect shipment contents for automatic accuracy checking. Our international distribution complexes include several advanced technology enhancements, such as radio frequency technology in product receiving processing to ensure accuracy, as well as an automated package routing and a pick-to-light paperless order fulfillment system. Our advanced distribution systems provide us with the capability to warehouse an extensive number of stock keeping units (SKUs) for our clients, ranging from large high-end laser printers to small cosmetic compacts. Our facilities are flexibly configured to process B2B and single pick B2C orders from the same central location.

During 2004, we warehoused, managed and fulfilled more than \$1.5 billion in client merchandise and transactions. Much of this does not represent our revenue, but rather the revenue of our clients' transactions for whom we provided business process outsourcing solutions. See "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Based upon our clients' needs, we are able to take advantage of a variety of shipping and delivery options, which range from next day service to zone skipping to optimize transportation costs. Our facilities and systems are equipped with multi-carrier functionality, allowing us to integrate with all leading package carriers and provide a comprehensive freight and transportation management offering. In addition, an increasingly important function that we provide for our clients is reverse logistics management. We offer a wide array of product return services for our clients, including issuing return authorizations, receipt of product, crediting customer accounts, and disposition of returned product.

Domestic clients of PFSweb enjoy the benefits of having their inventory assets secured by a network of trained law enforcement professionals, who have developed and continue to operate a world-class security network from our security headquarters in Memphis, TN. As part of our services are for the United States Government, our security plans and procedures are under constant evaluation and evolution. Continual validation ensures that we employ the latest in security processes and procedures to further enhance our surveillance and detection capabilities.

*Facility Operations and Management.* Our FOM service offering includes distribution facility design and optimization, business process reengineering and ongoing staffing and management. Along with our high-volume fulfillment center in Mississippi and our automated fulfillment center in Tennessee, we also manage an aircraft parts distribution center in Grapevine, Texas on behalf of Raytheon Aircraft Company. Our expertise in supply chain management, logistics and customer-centric fulfillment operations extends through our management of client-owned facilities, resulting in cost reductions, process improvements and technology-driven efficiencies.

*Kitting and Assembly Services.* Our expanded kitting and assembly services enable our clients to reduce the time and costs associated with managing multiple suppliers, warehousing hubs, and light manufacturing partners. As a single source provider, we provide clients with the advantage of convenience, accountability and speed. Our comprehensive kitting and assembly services provide a quality one-stop resource for any international channel. PFSweb's kitting and assembly service includes light assembly, specialized kitting and supplier-consigned inventory hub either in our distribution facilities or co-located elsewhere. We also offer customized light manufacturing and Supplier Relationship Management ("SRM") for Fortune 1000 and Global 2000 manufacturers.

We will work with clients to re-sequence certain supply chain activities to aid in an inventory postponement strategy. We can provide kitting and assembly services and build-to-stock thousands of units daily to stock in a Just-

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in-Time (“JIT”) environment. This service, for example, can entail the procurement of packaging materials including retail boxes, foam inserts and anti-static bags. These raw material components would be shipped to PFSweb from domestic or overseas manufacturers, and PFSweb will build the finished SKU units to stock for the client. This strategy allows manufacturers to make a smaller investment in inventory while meeting changing customer demand.

Combining our assembly services with our supplier-owned inventory hub services allows our clients to reduce cycle times, to compress their supply chains and to consolidate their operations and supplier management functions. We have supplier inventory management, assembly and fulfillment services all in one place, providing greater flexibility in product line utilization, as well as rapid response to change orders or packaging development. Our standard capabilities include: build-to-order, build-to-stock, expedited orders, passive and active electrostatic discharge (“ESD”) controls, product labeling, serial number generation, marking and/or capture, lot number generation, asset tagging, bill of materials (“BOM”) or computer automated design (“CAD”) engineering change processing, SKU-level pricing and billing, manufacturing and metrics reporting, first article approval processes, and comprehensive quality controls.

Our kitting and assembly services also include procurement. We work directly with client suppliers to make JIT inventory orders for each component in client packages, thereby ensuring the appropriate inventory quantities arrive at just the right time to PFSweb and then turned around JIT to customers.

Kitting and inventory hub services enable clients to collapse supply chains into the minimal steps necessary to prepare product for distribution to any channel, including wholesale, mass merchant retail, or direct to consumer. Clients no longer have to employ multiple providers or require suppliers to consign multiple inventory caches for each channel. We offer our clients the opportunity to consolidate operations from a channel standpoint, as well as from a geographic perspective. Our integrated, global information systems and international locations support client business needs worldwide.

*Information Management.* We have the ability to communicate with and transfer information to and from our clients through a wide variety of technology services, including real-time data interfaces, file transfer methods and electronic data interchange. Our systems are designed to capture, store and electronically forward to our clients critical information regarding customer inquiries and orders, product shipments, inventory status (for example, levels of inventory on hand, on backorder, on purchase order and inventory due dates to our warehouse), product returns and other information. We maintain for our clients detailed product databases that can be seamlessly integrated with their web sites utilizing the capabilities of the Entente Suite. Our systems are capable of providing our clients with customer inventory and order information for use in analyzing sales and marketing trends and introducing new products. We also offer customized reports and data analyses based upon specific client needs to assist them in their budgeting and business decision process.

*Financial Services.* Our financial services are divided into two major areas: 1) billing, credit and collection services for B2B and B2C clients and 2) working capital solutions, where we act as a virtual and physical financial management department to fulfill our clients’ needs.

We offer secure credit and collections services for both B2B and B2C businesses. Specifically, for B2C clients, we offer secure credit card processing related services for orders made via a client web site or through our customer contact center. We offer manual credit card order review as an additional level of fraud protection. We also calculate sales taxes, goods and services taxes or value added taxes, if applicable, for numerous taxing authorities and on a variety of products. Using third-party leading-edge fraud protection services and risk management systems, we can assure the highest level of security and the lowest level of risk for client transactions.

For B2B clients, we offer full-service accounts receivable management and collection capabilities, including the ability to generate customized computer-generated invoices in our clients’ names. We assist clients in reducing accounts receivable and days sales outstanding, while minimizing costs associated with maintaining an in-house collections staff. We offer electronic credit services in the format of EDI X.12 and XML communications direct from our clients to their vendors, suppliers and retailers.

Our subsidiary, Supplies Distributors, Inc. provides working capital solutions, which enable manufacturers to



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remove inventory and receivables from their balance sheets through the use of third party financing. This service offering is available to clients operating in North America and Europe.

While the majority of our clients maintain ownership of their own inventory, through Supplies Distributors, we can create and implement client inventory solutions as well. PFSweb has years of experience in dealing with the issues related to inventory ownership, secure inventory management, replenishment and product distribution. PFSweb and Supplies Distributors can offer prospective clients a management solution for the entire customer relationship, including ownership of inventory and receivables. Through CIP, we utilize technology resources to time the replenishment purchase of inventory with the simultaneous sale of product to the end user. All interfaces are done electronically and almost all processes regarding the financial transactions are automated, creating significant supply chain advantages.

PFSweb is experienced in the complex legal, accounting and governmental control issues that can be hurdles in the successful implementation of working capital financing programs. Our knowledge and experience help clients achieve supply chain benefits while reducing inventory-carrying costs. Substantial benefits and improvement to a company's balance sheet can be achieved through these working capital solutions.

*Professional Consulting Services.* As part of the tailored solution for our clients, we offer a full team of experts specifically designated to focus on our clients' businesses. Team members play a consultative role, providing constructive evaluation, analysis and recommendations for the client's business. This team creates customized solutions and devises plans that will increase efficiencies and produce benefits for the client when implemented.

Comprised of industry experts from top-tier consulting firms and industry market leaders, our team of professional consultants provides client service focus and logistics and distribution expertise. They have built solutions for Fortune 1000 and Global 2000 market leaders in a wide range of industries, including apparel, technology, telecommunications, cosmetics, aviation, housewares, high-value collectibles, sporting goods, pharmaceuticals and several more. Focusing on the evolving infrastructure needs of major corporations and their business initiatives, our team has a solid track record providing consulting services in the areas of supply chain management, distribution and fulfillment, technology interfacing, logistics and customer support.

## Clients and Marketing

Our target clients include Fortune 1000 and major brand name technology and consumer goods companies looking to quickly and efficiently implement or enhance business initiatives, adapt their go-to-market strategies, or introduce new products or programs, without the burden of modifying or expanding their technology, customer care, supply chain and logistics infrastructure. We also provide FOM solutions that include Process Reengineering, Facility Design and Employee Administration services. Our solutions are applicable to a multitude of industries and company types and we have provided solutions for such companies as:

International Business Machines ("IBM") (printer supplies in several geographic areas), Adaptec (computer accessories), the United States Government as a sub-contractor (high-value collectibles), Avaya Communication, Emtec Magnetics (a manufacturer of BASF-branded data media and audio visual products), CHiA'SSO (a contemporary home furnishings and decor cataloger), Xerox (printers and printer supplies), Pfizer (pharmaceuticals), Lancôme (a cosmetic division of L'Oreal), NokiaUSA.com (cell phone accessories), Roots Canada (apparel), Hewlett-Packard (printers and computer networking equipment), Flavia (a beverage division of Mars), Raytheon Aircraft Company (FOM and time-definite logistics supporting parts distribution) and The Smithsonian Business Ventures (a collectibles cataloger), amongst many others. We target potential clients through an extensive integrated marketing program that comprises a variety of direct marketing techniques, trade event participation, search engine marketing, public relations and a sophisticated outbound tele-sales lead generation model. We have also developed an intricate messaging matrix that defines our various business process outsourcing solutions and products, the vehicles we utilize to deliver marketing communication on these solutions/products and the target audience segments that display a demand for these solutions/products. This messaging matrix allows us to deploy highly targeted solution messages to selected key vertical industry segments where we feel that we are able to provide significant service differentiation and value. We also pursue strategic marketing alliances with consulting firms, software manufacturers and other logistics providers to increase market awareness and generate referrals and customer leads.

Because of the highly complex nature of the solutions we provide, our clients demand significant competence and experience from a variety of different business disciplines during the sales cycle. As such, we utilize a selected member of our senior executive team to lead the design and proposal development of each potential new client we choose to pursue. The senior executive is supported by a select group of highly experienced individuals from our professional services group with specific industry knowledge or experience to the solutions development process. We employ a team of highly trained implementation managers whose responsibilities include the oversight and supervision of client projects and maintaining high levels of client satisfaction during the transition process between the various stages of the sales cycle and steady state operations.

### Technology

We maintain advanced management information systems and have automated key business functions using on-line, real-time systems. These systems enable us to provide our clients information concerning sales, inventory status, customer payments and other operations that are essential for our clients to efficiently manage their electronic commerce and supply chain business programs. Our systems are designed to scale rapidly in order to handle the transaction processing demands of our clients.

We employ technology from a selected group of partners, some of whom are also our clients. For example, we deploy IBM e-servers and network printers in appropriate models to run web site functions as well as order management and distribution functions. We utilize Avaya Communication for telephone switch and call center management functions and to interact with customers via voice, e-mail or chat. Avaya Communication technology also allows us to share web pages between customers and our service representatives. We have the ability to transmit and receive voice, data and video simultaneously on a single network connection to a customer to more effectively serve that customer for our client. Clients' interest in using this technology stems from its ability to allow shoppers to consult with known experts in a way that the customer chooses prior to purchasing. Our sophisticated computer-telephony integration has been accomplished by combining systems software from IBM and Avaya Communication together with our own application development. We use AT&T for our private enterprise network and long distance carrier. We use J.D. Edwards as the software provider for the primary ERP applications that we use in our operational areas and financial areas. We use Ecometry as the software provider for the primary multi-channel direct marketing application we deploy for our catalog and direct marketing clients. We use Siemens Dematic/Rapistan Materials Handling Automation for our automated order selection, automated conveyor and "pick-to-light" (inventory retrieval) systems, and Symbol Technologies/Telxon for our warehouse radio frequency applications. Our Warehouse Management System ("WMS") and Distribution Requirements Planning ("DRP") system have been developed in-house to meet the varied unique requirements of our vertical markets. Both the WMS and DRP are tightly integrated to both the North American and European deployments of our J.D. Edwards' system.

Many internal infrastructures are not sufficient to support the explosive growth in e-business, e-marketplaces, supply chain compression, distribution channel realignment and the corresponding demand for real-time information necessary for strategic decision-making and product fulfillment. To address this need, we have created the Entente Suite, which is a comprehensive suite of technology services, with supporting software and hardware infrastructure, that enables companies with little or no e-commerce infrastructure to speed their time to market and minimize resource investment and risk, and allows all companies involved to improve the efficiency of their supply chain. The Entente Suite is comprised of four distinct service offerings — EntenteWeb, EntenteDirect, EntenteMessage, and EntenteReport — that can stand alone or be combined for a fully customized e-commerce solution depending on the level of direct involvement a company wants to maintain in their e-commerce initiative.

The components of the Entente Suite provide the open platform service infrastructure that allows us to create complete e-commerce solutions with our customers. Using the various services of the Entente Suite, we can assist our clients in easily integrating their web sites or ERP systems to our systems for real-time transaction processing without regard for their hardware platform or operating system. This high-level of systems integration allows our clients to automatically process orders, customer data and other e-commerce information. We also can track information sent to us by the client as it moves through our systems in the same manner a carrier would track a package throughout the delivery process. Our systems enable us to track, at a detailed level, information received, transmission timing, any errors or special processing required and information sent back to the client. The transactional and management information contained within our systems is made available to the client quickly and



easily through the Entente Suite.

The Entente Suite serves as a transparent interface to our back-office productivity applications including our customized J.D. Edwards order management and fulfillment application and our Ecometry multi-channel direct marketing application that runs on IBM's e-Server xSeries servers. It also is designed to integrate with marketplace technologies offered by major marketplace software companies. PFSweb utilizes Gentran Integration Suite™ ("GIS") as our technology platform for Enterprise Application Integration with our clients and client's trading partners. With GIS, we have greatly increased our ability to quickly design and deploy customized B2B e-commerce solutions for our clients by utilizing a robust business process modeling tool and a highly scalable operating infrastructure. This platform facilitates the efficient and secure exchange of electronic business transactions/documents in a wide variety of formats (i.e. XML, X.12 EDI, delimited text, IDOCS, RosettaNet) and communication protocols (i.e. FTP/SFTP, HTTP/HTTPS, SMTP).

To enhance our service offerings, we have invested in advanced telecommunications, computer telephony, electronic mail and messaging, automated fax technology, IVR technology, barcode scanning, wireless technology, fiber optic network communications and automated inventory management systems. We have also developed and utilize telecommunications technology that provides for automatic customer call recognition and customer profile recall for inbound customer service representatives.

The primary responsibility of our systems development team of IT professionals is directed at implementing custom solutions for new clients and maintaining existing client relationships. Our development team can also produce proprietary systems infrastructure to expand our capabilities in circumstances where we cannot purchase standard solutions from commercial providers. We also utilize temporary resources when needed for additional capacity.

Our information technology operations and infrastructure are built on the premise of reliability and scalability. We maintain diesel generators and un-interruptible power supply equipment to provide constant availability to computer rooms, call centers and warehouses. Multiple Internet service providers and redundant web servers provide for a high degree of availability to web sites that interface with our systems. Capacity planning and upgrading is performed regularly to allow for quick implementation of new clients and avoid time-consuming infrastructure upgrades that could slow growth rates. We also have a disaster recovery plan for our information systems and maintain a "hot site" under contract with a major provider.

## Competition

Many companies offer, on an individual basis, one or more of the same services we do, and we face competition from many different sources depending upon the type and range of services requested by a potential client. Our competitors include vertical outsourcers, which are companies that offer a single function solution, such as call centers, public warehouses or credit card processors. We compete against transportation logistics providers, known in the industry as 3PL's and 4PL's, who offer product management functions as an ancillary service to their primary transportation services. We also compete against other business process outsourcing providers, who perform many similar services as us. Many of these companies have greater capabilities than we do for the single or multiple functions they provide. In many instances, our competition is the in-house operations of our potential clients themselves. The in-house operations departments of potential clients often believe that they can perform the same services we do, while others are reluctant to outsource business functions that involve direct customer contact. We cannot be certain that we will be able to compete successfully against these or other competitors in the future.

Although many of our competitors can offer one or more of our services, we believe our primary competitive advantage is our ability to offer a wide array of customized services that cover a broad spectrum of business processes, including web-site design and hosting, kitting and assembly, order processing and shipment, credit card payment and customer service, thereby eliminating any need for our clients to coordinate these services from many different providers. We believe we are unique in offering our clients a very broad range of business process services that addresses, in many cases, the entire business transaction, from demand to delivery.

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We also compete on the basis of many other important additional factors, including:

- operating performance and reliability;
- ease of implementation and integration;
- experience of the people required to successfully and efficiently design and implement solutions;
- leading edge technology capabilities;
- global reach; and
- price.

We believe that we compete favorably with respect to each of these factors. However, the market for our services is competitive and still evolving, and we may not be able to compete successfully against current and future competitors.

### Employees

As of December 31, 2004, we had 799 full-time employees and 82 part-time employees, of which 819 were located in the United States. We are not a party to any collective bargaining agreements, and we have never suffered an interruption of business as a result of a labor dispute. We consider our relationship with our employees to be good.

Our success in recruiting, hiring and training large numbers of skilled employees and obtaining large numbers of hourly employees during peak periods for distribution and call center operations is critical to our ability to provide high quality distribution and support services. Call center representatives and distribution personnel receive feedback on their performance on a regular basis and, as appropriate, are recognized for superior performance or given additional training. Generally, our clients provide specific product training for our customer service representatives and, in certain instances, on-site client personnel to provide specific technical support. To maintain good employee relations and to minimize employee turnover, we offer competitive pay, hire primarily full-time employees who are eligible to receive a full range of employee benefits, and provide employees with clear, visible career paths.

### Internet Access to Reports

We maintain an Internet website, [www.pfsweb.com](http://www.pfsweb.com). Our annual reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K (and amendments, if any, to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934) are made available, free of charge, through the investor relations section of this website as soon as reasonably practicable after we electronically file such material, or furnish it to the Securities and Exchange Commission. The information on our website is not incorporated in this report.

### Regulation

Our business may be affected by current and future governmental regulation, both foreign and domestic. For example, the internet Tax Freedom Act bars state and local governments from imposing taxes on internet access or that would subject buyers and sellers of electronic commerce to taxation in multiple states. This act is in effect until November 1, 2006. If legislation to extend this act or similar legislation is not enacted, internet access and sales across the Internet may be subject to additional taxation by state and local governments, thereby discouraging purchases over the Internet and adversely affecting the market for our services.

### RISK FACTORS

*Our business, financial condition and operating results could be adversely affected by any of the following factors, in which event the trading price of our common stock could decline, and you could lose part or all of your investment. The risks and uncertainties described below are not the only ones that we face. Additional risks and uncertainties not presently known to us, or that we currently think are immaterial, may also impair our business operations.*

### Risks Related to Our Business

***Our historical financial information may not be representative of our future results.***

Prior to our initial public offering in December 1999, we were a wholly-owned subsidiary of Daisytek International Corporation (“Daisytek”). We completed our separation from Daisytek on July 6, 2000 through a pro rata distribution to Daisytek’s common stockholders of all of the shares of our common stock that Daisytek then held.

The financial information for the periods ended March 31, 2001 included in this Form 10-K may not reflect what our results of operations, financial position and cash flows would have been had we been a separate, stand-alone entity during the periods presented. This is because we made certain adjustments and allocations since Daisytek did not account for us as, and we were not operated as, a single stand-alone business for the periods presented.

We cannot assure you that the adjustments and allocations we made in preparing our historical consolidated financial statements appropriately reflect our operations during such period as if we had, in fact, operated as a stand-alone entity or what the actual effect of our separation from Daisytek would have been. Accordingly, we cannot assure you that our historical results of operations are indicative of our future operating or financial performance.

The financial information for the periods October 1, 1999 to October 1, 2002 reflect our agreements with IBM and master distributors of certain IBM products (until July 2001 a Daisytek subsidiary, and from July 2001 until September 2002, Supplies Distributors, Inc. (“Supplies Distributors”), our then 49% owned subsidiary). Under these agreements, the master distributors owned and distributed the IBM product and we provided transaction management and fulfillment services to the master distributors. Under these agreements, we did not own the IBM product and our revenue was service fee revenue (based on product sales volume or other transaction based pricing) and not product revenue.

In October 2002, we acquired the remaining 51% ownership interest in Supplies Distributors and we now consolidate 100% of Supplies Distributors financial position and results of operations into our consolidated financial statements. Upon consolidation, effective October 1, 2002, we own the IBM product and record product revenue as the product is sold to IBM customers.

As a result of reflecting revenue earned under the master distributor agreements as product revenue in certain historical periods and as service fee revenue in others, our historical results of operations may not be indicative of our future operating or financial performance.

***We anticipate incurring significant expenses in the foreseeable future, which may reduce our ability to achieve or maintain profitability.***

To reach our business growth objectives, we may increase our operating and marketing expenses, as well as capital expenditures. To offset these expenses, we will need to generate additional profitable business. If our revenue grows slower than either we anticipate or our clients’ projections indicate, or if our operating and marketing expenses exceed our expectations, we may not generate sufficient revenue to be profitable or be able to sustain or increase profitability on a quarterly or an annual basis in the future. Additionally, if our revenue grows slower than either we anticipate or our clients’ projections indicate, we may incur unnecessary or redundant costs and our operating results could be adversely affected. We also expect to incur additional expenses beginning in July 2005 upon the adoption of Statement on Financial Accounting Standards No. 123R, Accounting for Stock-based Compensation.

***Our service fee revenue and gross margin is dependent upon our clients’ business and transaction volumes and our costs; many of our client service agreements are terminable by the client at will; we may incur financial penalties if we fail to meet contractual service levels under certain client service agreements.***

Our service fee revenue is primarily transaction based and fluctuates with the volume of transactions or level of sales of the products by our clients for whom we provide transaction management services. If we are unable to retain existing clients or attract new clients or if we dedicate significant resources to clients whose business does not

generate sufficient revenue or whose products do not generate substantial customer sales, our business may be materially adversely affected. Moreover, our ability to estimate service fee revenue for future periods is substantially dependent upon our clients' and our own projections, the accuracy of which has been, and will continue to be, unpredictable. Therefore, our planning for client activity and targeted goals for service fee revenue and gross margin may be materially adversely affected by incomplete, delayed or inaccurate projections. In addition, many of our service agreements with our clients are terminable by the client at will. Therefore, we cannot assure you that any of our clients will continue to use our services for any period of time. The loss of a significant amount of service fee revenue due to client terminations could have a material adverse effect on our ability to cover our costs and thus on our profitability. Certain of our client service agreements contain minimum service level requirements and impose financial penalties if we fail to meet such requirements. The imposition of a substantial amount of such penalties could have a material adverse effect on our business and operations.

***Our operating results are materially impacted by our client mix and the seasonality of their business.***

Our business is materially impacted by our client mix and the seasonality of their business. Based upon our current client mix and their current projected business volumes, we anticipate our service fee revenue business activity will be at its lowest in the first quarter of our fiscal year and that our product revenue business activity will be at its highest in the fourth quarter of our fiscal year. We believe results of operations for a quarterly period may not be indicative of the results for any other quarter or for the full year. We are unable to predict how the seasonality of future clients' business may affect our quarterly revenue and whether the seasonality may change due to modifications to a client's business. As such, we believe that results of operations for a quarterly period may not be indicative of the results for any other quarter or for the full year.

***Our systems may not accommodate significant growth in our number of clients.***

Our success depends on our ability to handle a large number of transactions for many different clients in various product categories. We expect that the volume of transactions will increase significantly as we expand our operations. If this occurs, additional stress will be placed upon the network hardware and software that manages our operations. We cannot assure you of our ability to efficiently manage a large number of transactions. If we are not able to maintain an appropriate level of operating performance, we may develop a negative reputation, and impair existing and prospective client relationships and our business would be materially adversely affected.

***We may not be able to recover all or a portion of our start-up costs associated with one or more of our clients.***

We generally incur start-up costs in connection with the planning and implementation of business process solutions for our clients. Although we generally attempt to recover these costs from the client in the early stages of the client relationship, or upon contract termination if the client terminates without cause prior to full amortization of these costs, there is a risk that the client contract may not fully cover the start-up costs. To the extent start-up costs exceed the start-up fees received, excess costs will be expensed as incurred. Additionally, in connection with new client contracts we generally incur capital expenditures associated with assets whose primary use is related to the client solution. There is a risk that the contract may end before expected and we may not recover the full amount of our capital costs.

***Our revenue and margins may be materially impacted by client transaction volumes that differ from client projections and business assumptions.***

Our pricing for client transaction services, such as call center and fulfillment, is often based upon volume projections and business assumptions provided by the client and our anticipated costs to perform such work. In the event the actual level of activity or cost is substantially different from the projections or assumptions, we may have insufficient or excess staffing, incremental costs or other assets dedicated for such client that may negatively impact our margins and business relationship with such client. In the event we are unable to meet the service levels expected by the client, our relationship with the client will suffer and may result in financial penalties and/or the termination of the client contract.

### ***Our business is subject to the risk of customer and supplier concentration.***

For the years ended December 31, 2004 and 2003, a U.S. government agency (via a subcontract agreement with IBM) and Xerox Corporation (“Xerox”) represented approximately 40%, and 15%, respectively, of our total service fee revenue for both periods. The loss of, or non-payment of invoices by, either or both of such U.S. agency or Xerox as clients would have a material adverse effect upon our business. In particular, the agreement under which we provide services to such clients are terminable at will upon notice by such clients.

Substantially all of our product revenue was generated by sales of product purchased under master distributor agreements with IBM and is dependent on IBM’s business. Our product revenue business is dependent upon our master distributor relationship with IBM and the continuing market for IBM products. A termination of the relationship with IBM or a decline in customer demand for such products could have a material adverse effect on our business. Sales to two customers accounted for approximately 12% and 11% of our total product revenues for the year ended December 31, 2004. Sales to three customers accounted for approximately 13%, 12% and 10% of our total product revenues for the year ended December 31, 2003. The loss of any one or more of such customers, or non-payment of any material amount by these or any other customer, would have a material adverse effect upon our business.

### ***Changes to financial accounting standards may affect our reported results of operations.***

We prepare our financial statements to conform to generally accepted accounting principles, or GAAP. GAAP are subject to interpretation by the American Institute of Certified Public Accountants, the SEC and various bodies formed to interpret and create appropriate accounting policies. A change in those policies can have a significant effect on our reported results and may even affect our reporting of transactions completed before a change is announced. Accounting rules affecting many aspects of our business, including rules relating to accounting for asset impairments, revenue recognition, arrangements involving multiple deliverables, employee stock purchase plans and stock option grants have recently been revised or are currently under review. Changes to those rules or current interpretation of those rules may have a material adverse effect on our reported financial results or on the way we conduct our business.

### ***We operate with significant levels of indebtedness and are required to comply with certain financial and non-financial covenants; we are required to maintain a minimum level of subordinated loans to our subsidiary Supplies Distributors; and we are obligated to repay any over-advance made to Supplies Distributors by its lenders.***

As of December 31, 2004, our total credit facilities outstanding, including debt, capital lease obligations and our vendor accounts payable related to financing of IBM product inventory, was approximately \$66.4 million. Certain of the credit facilities have maturity dates in calendar year 2006 or after, but are classified as current liabilities in our consolidated financial statements. We cannot provide assurance that our credit facilities will be renewed by the lending parties. Additionally, these credit facilities include both financial and non-financial covenants, many of which also include cross default provisions applicable to other agreements. We cannot provide assurance that we will be able to maintain compliance with these covenants. Any non-renewal or any default under any of our credit facilities would have a material adverse impact upon our business and financial condition. In addition we have provided \$7.0 million of subordinated indebtedness to Supplies Distributors, the minimum level required under certain credit facilities as of December 31, 2004. The maximum level of this subordinated indebtedness to Supplies Distributors that may be provided without approval from our lenders is \$8.0 million. The restrictions on increasing this amount without lender approval may limit our ability to comply with certain loan covenants or further grow and develop Supplies Distributors’ business. We have guaranteed most of the indebtedness of Supplies Distributors. Furthermore, we are obligated to repay any over-advance made to Supplies Distributors by its lenders to the extent Supplies Distributors is unable to do so.

### ***We face competition from many sources that could adversely affect our business.***

Many companies offer, on an individual basis, one or more of the same services we do, and we face competition from many different sources depending upon the type and range of services requested by a potential client. Our competitors include vertical outsourcers, which are companies that offer a single function, such as call centers,

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public warehouses or credit card processors. We compete against transportation logistics providers who offer product management functions as an ancillary service to their primary transportation services. We also compete against other business process outsourcing providers, who perform many similar services as us. Many of these companies have greater capabilities than we do for the single or multiple functions they provide. In many instances, our competition is the in-house operations of our potential clients themselves. The in-house operations departments of potential clients often believe that they can perform the same services we do, while others are reluctant to outsource business functions that involve direct customer contact. We cannot be certain that we will be able to compete successfully against these or other competitors in the future.

***Our sales and implementation cycles are highly variable and our ability to finalize pending contracts may cause our operating results to vary widely.***

The sales cycle for our services is variable, typically ranging between several months to up to a year from initial contact with the potential client to the signing of a contract. Occasionally the sales cycle requires substantially more time. Delays in signing and executing client contracts may affect our revenue and cause our operating results to vary widely. We believe that a potential client's decision to purchase our services is discretionary, involves a significant commitment of its resources and is influenced by intense internal and external pricing and operating comparisons. To successfully sell our services, we generally must educate our potential clients regarding the use and benefit of our services, which can require significant time and resources. Consequently, the period between initial contact and the purchase of our services is often long and subject to delays associated with the lengthy approval and competitive evaluation processes that typically accompany significant operational decisions. Additionally, the time required to finalize pending contracts and to implement our systems and integrate a new client can range from several weeks to many months. Delays in signing and integrating new clients may affect our revenue and cause our operating results to vary widely.

***We are dependent on our key personnel, and we need to hire and retain skilled personnel to sustain our business.***

Our performance is highly dependent on the continued services of our executive officers and other key personnel, the loss of any of whom could materially adversely affect our business. In addition, we need to attract and retain other highly-skilled, technical and managerial personnel for whom there is intense competition. We cannot assure you that we will be able to attract and retain the personnel necessary for the continuing growth of our business. Our inability to attract and retain qualified technical and managerial personnel would materially adversely affect our ability to maintain and grow our business.

***We are subject to risks associated with our international operations.***

We currently operate a 150,000 square foot distribution center in Liege, Belgium and a 13,000 square foot distribution center in Richmond Hill, Canada, near Toronto, both of which currently have excess capacity. We cannot assure you that we will be successful in expanding in these or any additional international markets. In addition to the uncertainty regarding our ability to generate revenue from foreign operations and expand our international presence, there are risks inherent in doing business internationally, including:

- changing regulatory requirements;
- legal uncertainty regarding foreign laws, tariffs and other trade barriers;
- political instability;
- potentially adverse tax consequences;
- foreign currency fluctuations; and
- cultural differences.

Any one or more of these factors could materially adversely affect our business in a number of ways, such as increased costs, operational difficulties and reductions in revenue.

***We are uncertain about our need for and the availability of additional funds.***

Our future capital needs are difficult to predict. We may require additional capital to take advantage of unanticipated opportunities, including strategic alliances and acquisitions and to fund capital expenditures, or to respond to changing business conditions and unanticipated competitive pressures. In addition, we may require



additional funds to finance operating losses. Should these circumstances arise, our existing cash balance and credit facilities may be insufficient and we may need to raise additional funds either by borrowing money or issuing additional equity. We cannot assure you that such resources will be adequate or available for all of our future financing needs. Our inability to finance our growth, either internally or externally, may limit our growth potential and our ability to execute our business strategy. If we are successful in completing an additional equity financing, this could result in further dilution to our stockholders or reduce the market value of our common stock.

***We may engage in future strategic alliances or acquisitions that could dilute our existing stockholders, cause us to incur significant expenses or harm our business.***

We may review strategic alliance or acquisition opportunities that would complement our current business or enhance our technological capabilities. Integrating any newly acquired businesses, technologies or services may be expensive and time-consuming. To finance any acquisitions, it may be necessary for us to raise additional funds through borrowing money or completing public or private financings. Additional funds may not be available on terms that are favorable to us and, in the case of equity financings, may result in dilution to our stockholders. We may not be able to operate any acquired businesses profitably or otherwise implement our growth strategy successfully. If we are unable to integrate any newly acquired entities or technologies effectively, our operating results could suffer. Future acquisitions by us could also result in incremental expenses and the incurrence of debt and contingent liabilities, any of which could harm our operating results.

***Our business could be adversely affected by a systems or equipment failure, whether our own or of our clients.***

Our operations are dependent upon our ability to protect our distribution facilities, customer service centers, computer and telecommunications equipment and software systems against damage and failures. Damage or failures could result from fire, power loss, equipment malfunctions, system failures, natural disasters and other causes. If our business is interrupted either from accidents or the intentional acts of others, our business could be materially adversely affected. In addition, in the event of widespread damage or failures at our facilities, our short-term disaster recovery and contingency plans and insurance coverage may not be sufficient.

Our clients' businesses may also be harmed from any system or equipment failures we experience. In that event, our relationship with these clients may be adversely affected, we may lose these clients, our ability to attract new clients may be adversely affected and we could be exposed to liability.

Interruptions could also result from the intentional acts of others, like "hackers." If our systems are penetrated by computer hackers, or if computer viruses infect our systems, our computers could fail or proprietary information could be misappropriated.

If our clients suffer similar interruptions in their operations, for any of the reasons discussed above or for others, our business could also be adversely affected. Many of our clients' computer systems interface with our own. If they suffer interruptions in their systems, the link to our systems could be severed and sales of their products could be slowed or stopped.

***A breach of our e-commerce security measures could reduce demand for our services. Credit card fraud and other fraud could adversely affect our business.***

A requirement of the continued growth of e-commerce is the secure transmission of confidential information over public networks. A party who is able to circumvent our security measures could misappropriate proprietary information or interrupt our operations. Any compromise or elimination of our security could reduce demand for our services.

We may be required to expend significant capital and other resources to protect against security breaches or to address any problem they may cause. Because our activities involve the storage and transmission of proprietary information, such as credit card numbers, security breaches could damage our reputation, cause us to lose clients, impact our ability to attract new clients and we could be exposed to litigation and possible liability. Our security measures may not prevent security breaches, and failure to prevent security breaches may disrupt our operations. We do not carry insurance against the risk of credit card fraud and other fraud, so the failure to adequately control

fraudulent transactions on our client's behalf could increase our expenses. To date we have not suffered material losses due to fraud.

***We may be a party to litigation involving our e-commerce intellectual property rights.***

In recent years, there has been significant litigation in the United States involving patent and other intellectual property rights. We may be a party to intellectual property litigation in the future to protect our trade secrets or know-how. United States patent applications are confidential until a patent is issued and most technologies are developed in secret. Accordingly, we are not, and cannot be, aware of all patents or other intellectual property rights of which our services may pose a risk of infringement. Others asserting rights against us could force us to defend ourselves or our customers against alleged infringement of intellectual property rights. We could incur substantial costs to prosecute or defend any such litigation.

***If we fail to maintain an effective system of internal controls, we may not be able to accurately report our financial results or prevent fraud. As a result, current and potential stockholders could lose confidence in our financial reporting, which could harm our business, and the trading price of our common stock.***

We have begun a process to document and evaluate our internal controls over financial reporting to satisfy the requirements of Section 404 of the Sarbanes-Oxley Act, which requires annual management assessments of the effectiveness of our internal controls over financial reporting and a report by our independent auditors addressing these assessments. Based on the current requirements, and our current public float, we are not required to comply with Section 404 until 2006. If our public float increases to more than \$75 million as of June 30, 2005, we will be required to comply in 2005. However, in this regard, management has been dedicating internal resources, has engaged outside consultants and has begun to develop a detailed work plan to (i) assess and document the adequacy of internal controls over financial reporting, (ii) take steps to improve control processes, where appropriate, and (iii) validate through testing that controls are functioning as documented. If we fail to correct any issues in the design or operating effectiveness of internal controls over financial reporting or fail to prevent fraud, current and potential stockholders could lose confidence in our financial reporting, which could harm our business and the trading price of our common stock.

## **Risks Related to Our Industry**

***If the trend toward outsourcing does not continue, our business will be adversely affected.***

Our business could be materially adversely affected if the trend toward outsourcing declines or reverses, or if corporations bring previously outsourced functions back in-house. Particularly during general economic downturns, businesses may bring in-house previously outsourced functions to avoid or delay layoffs. The continued threat of terrorism within the United States and abroad and the potential for sustained military action may cause disruption to commerce and economic conditions, both domestic and foreign, which could have a material adverse effect upon our business and new client prospects.

***Our market is subject to rapid technological change and to compete we must continually enhance our systems to comply with evolving standards.***

To remain competitive, we must continue to enhance and improve the responsiveness, functionality and features of our services and the underlying network infrastructure. If we are unable to adapt to changing market conditions, client requirements or emerging industry standards, our business could be adversely affected. The internet and e-commerce environments are characterized by rapid technological change, changes in user requirements and preferences, frequent new product and service introductions embodying new technologies and the emergence of new industry standards and practices that could render our technology and systems obsolete. Our success will depend, in part, on our ability to both internally develop and license leading technologies to enhance our existing services and develop new services. We must continue to address the increasingly sophisticated and varied needs of our clients and respond to technological advances and emerging industry standards and practices on a cost-effective and timely basis. The development of proprietary technology involves significant technical and business risks. We may fail to develop new technologies effectively or to adapt our proprietary technology and systems to client requirements or emerging industry standards.



### Risks Related to Our Stock

***Our stock price could decline if a significant number of shares become available for sale.***

In November 2003 we issued in a private placement transaction warrants to purchase an aggregate of 921,178 shares of common stock, of which 395,486 warrants (having an exercise price of \$ 3.30 per share) currently remain outstanding. In addition, as of December 31, 2004, we have an aggregate of 4,915,376 stock options outstanding to employees, directors and others with a weighted average exercise price of \$1.10 per share. The shares of common stock that may be issued upon exercise of these warrants and options may be resold into the public market. Sales of substantial amounts of common stock in the public market as a result of the exercise of these warrants or options, or the perception that future sales of these shares could occur, could reduce the market price of our common stock and make it more difficult to sell equity securities in the future.

***The market price of our common stock may be volatile. You may not be able to sell your shares at or above the price at which you purchased such shares.***

The trading price of our common stock may be subject to wide fluctuations in response to quarter-to-quarter fluctuations in operating results, announcements of material adverse events, general conditions in our industry or the public marketplace and other events or factors. In addition, stock markets have experienced extreme price and trading volume volatility in recent years. This volatility has had a substantial effect on the market prices of securities of many technology related companies for reasons frequently unrelated to the operating performance of the specific companies. These broad market fluctuations may adversely affect the market price of our common stock. In addition, if our operating results differ from our announced guidance or the expectations of equity research analysts or investors, the price of our common stock could decrease significantly.

***Our certificate of incorporation, our bylaws, our shareholder rights plan and Delaware law make it difficult for a third party to acquire us, despite the possible benefit to our stockholders.***

Provisions of our certificate of incorporation, our bylaws, our shareholder rights plan and Delaware law could make it more difficult for a third party to acquire us, even if doing so would be beneficial to our stockholders. For example, our certificate of incorporation provides for a classified board of directors, meaning that only approximately one-third of our directors may be subject to re-election at each annual stockholder meeting. Our certificate of incorporation also permits our Board of Directors to issue one or more series of preferred stock which may have rights and preferences superior to those of the common stock. The ability to issue preferred stock could have the effect of delaying or preventing a third party from acquiring us. We have also adopted a shareholder rights plan. These provisions could discourage takeover attempts and could materially adversely affect the price of our stock. In addition, because we are incorporated in Delaware, we are governed by the provisions of Section 203 of the Delaware General Corporation Law, which may prohibit large stockholders from consummating a merger with, or acquisition of us. These provisions may prevent a merger or acquisition that would be attractive to stockholders and could limit the price that investors would be willing to pay in the future for our common stock.

***There are limitations on the liabilities of our directors and executive officers.***

Pursuant to our bylaws and under Delaware law, our directors are not liable to us or our stockholders for monetary damages for breach of fiduciary duty, except for liability for breach of a director's duty of loyalty, acts or omissions by a director not in good faith or which involve intentional misconduct or a knowing violation of law, or any transaction in which a director has derived an improper personal benefit.

**Item 2. *Properties***

Our PFSweb business is headquartered in a central office facility located in Plano, Texas, a Dallas suburb.

In the U.S., we operate a central distribution complex in Memphis, Tennessee, which includes floor and mezzanine space of approximately 1 million square feet. We also operate a 600,000 square foot distribution facility in Southaven, Mississippi. Both of these complexes are located approximately five miles from the Memphis International Airport, where both Federal Express and United Parcel Service operate large hub facilities. We also manage a 200,000 square foot distribution facility in Grapevine, Texas.

We operate a 150,000 square foot distribution center in Liege, Belgium, which contains advanced distribution systems and equipment. We also operate a 13,000 square foot distribution center in Richmond Hill, Canada, near Toronto. We operate customer service centers in Memphis, Tennessee; Plano, Texas; and Liege, Belgium. Our call center technology permits the automatic routing of calls to available customer service representatives in several of our call centers.

Except for the Grapevine, Texas facility, which we manage on our client's behalf, all of our facilities are leased and the material lease agreements contain one or more renewal options.

**Item 3. *Legal Proceedings***

None.

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

None.

## PART II

### Item 5. *Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities*

Our common stock is listed and currently trades on the NASDAQ SmallCap Stock Market under the symbol “PFSW.” The following table sets forth for the period indicated the high and low sale price for the common stock as reported by NASDAQ:

	Price	
	High	Low
Year Ended December 31, 2003		
First Quarter	\$ 0.50	\$ 0.35
Second Quarter	\$ 0.79	\$ 0.34
Third Quarter	\$ 2.86	\$ 0.59
Fourth Quarter	\$ 3.25	\$ 1.37
Year Ended December 31, 2004		
First Quarter	\$ 2.15	\$ 1.59
Second Quarter	\$ 1.85	\$ 1.30
Third Quarter	\$ 1.69	\$ 1.20
Fourth Quarter	\$ 3.60	\$ 1.45

As of March 24, 2005, there were approximately 6,324 shareholders of which 148 were record holders of the common stock.

We have never declared or paid cash dividends on our common stock and do not anticipate the payment of cash dividends on our common stock in the foreseeable future. We are also restricted from paying dividends under our debt agreements, without the prior approval of our lenders. We currently intend to retain all earnings to finance the further development of our business. The payment of any future cash dividends will be at the discretion of our Board of Directors and will depend upon, among other things, future earnings, operations, capital requirements, the general financial condition of the Company and general business conditions and the approval of our lenders. See “Management’s Discussion and Analysis of Financial Condition and Results of Operations — Liquidity and Capital Resources.”

### Item 6. *Selected Consolidated Financial Data*

#### Historical Presentation

In June 2001, we announced a change in our fiscal year end from March 31 to December 31.

The selected consolidated historical statement of operations data for the years ended December 31, 2004, 2003 and 2002, and the selected consolidated balance sheet data as of December 31, 2004 and 2003 have been derived from our audited consolidated financial statements, and should be read in conjunction with those statements and notes, which are included in this Form 10-K. The selected consolidated statement of operations data for the year ended March 31, 2001 and the nine months ended December 31, 2001 and the selected consolidated balance sheet data as of December 31, 2002 and 2001 and March 31, 2001 have been derived from our audited consolidated financial statements, and should be read in conjunction with those statements, which are not included in this Form 10-K. The selected consolidated statement of operations data for the twelve months ended December 31, 2001 and nine months ended December 31, 2000, and the selected consolidated balance sheet data as of December 31, 2000 have been derived from our unaudited interim condensed consolidated financial statements, and should be read in conjunction with those statements, which are not included in this Form 10-K.

The financial information for the periods ended March 31, 2001 herein may not necessarily reflect what our results of operations, financial position and cash flows would have been had we been a separate, stand-alone entity during the periods presented. This is because we made certain adjustments and allocations since Daisytek did not account for us as, and we were not operated as, a single stand-alone business for the periods presented.

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The selected consolidated financial data should be read in conjunction with “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” “Risks Related to Our Business — Our historical financial information may not be representative of our future results,” and the consolidated financial statements and notes thereto that are included elsewhere in this Form 10-K.

### Historical Selected Condensed Consolidated Financial Data (In thousands, except per share data)

	Year Ended December 31,				Nine Months Ended December 31,		Year Ended March 31,
	2004	2003	2002	2001 (Unaudited)	2001 (a)	2000 (Unaudited)	2001
<b>Condensed Consolidated Statements of Operations Data:</b>							
Revenues:							
Product revenue, net	\$267,470	\$249,230	\$ 57,492	\$ —	\$ —	\$ —	\$ —
Service fee revenue	42,076	33,771	35,825	39,194	27,953	37,017	48,258
Pass-through revenue	12,119	3,435	3,692	5,118	3,721	5,554	6,952
Other revenue	—	—	—	497	100	1,700	2,097
Total revenues	<u>321,665</u>	<u>286,436</u>	<u>97,009</u>	<u>44,809</u>	<u>31,774</u>	<u>44,271</u>	<u>57,307</u>
Costs of revenues:							
Cost of product revenue	251,968	235,317	54,343	—	—	—	—
Cost of service fee revenue	28,067	23,159	22,660	25,840	18,209	26,790	34,421
Cost of pass-through revenue	12,119	3,435	3,692	5,118	3,721	5,554	6,952
Cost of other revenue	—	—	—	(568)	(627)	2,411	2,470
Total costs of revenues	<u>292,154</u>	<u>261,911</u>	<u>80,695</u>	<u>30,390</u>	<u>21,303</u>	<u>34,755</u>	<u>43,843</u>
Gross profit	29,511	24,525	16,314	14,419	10,471	9,516	13,464
Percent of revenues	9.2 %	8.6 %	16.8 %	32.2 %	33.0 %	21.5 %	23.5 %
Selling, general and administrative expenses	27,091	25,442	27,012	23,254	16,892	18,924	25,286
Severance and other termination costs	—	—	1,213	—	—	—	—
Asset and lease impairments	—	257	922	—	—	—	—
Other	—	—	—	(5,141)	(5,141)	—	—
Income (loss) from operations	2,420	(1,174)	(12,833)	(3,694)	(1,280)	(9,408)	(11,822)
Percent of revenues	0.8 %	(0.4) %	(13.2) %	(8.2) %	(4.0) %	(21.3) %	(20.6) %
Equity in earnings of affiliate	—	—	1,163	—	—	—	—
Interest expense (income), net	1,460	2,000	(161)	(707)	(496)	(880)	(1,091)
Income (loss) before income taxes and extraordinary item	960	(3,174)	(11,509)	(2,987)	(784)	(8,528)	(10,731)
Income tax expense (benefit)	734	572	94	(230)	(219)	36	25
Income (loss) before extraordinary item	226	(3,746)	(11,603)	(2,757)	(565)	(8,564)	(10,756)
Extraordinary item — gain on purchase of 51% share of Supplies Distributors	—	—	203	—	—	—	—
Net income (loss)	<u>\$ 226</u>	<u>\$ (3,746)</u>	<u>\$ (11,400)</u>	<u>\$ (2,757)</u>	<u>\$ (565)</u>	<u>\$ (8,564)</u>	<u>\$ (10,756)</u>
<b>Per share data:</b>							
Net income (loss) per share:							
Basic	<u>\$ 0.01</u>	<u>\$ (0.20)</u>	<u>\$ (0.63)</u>	<u>\$ (0.15)</u>	<u>\$ (0.03)</u>	<u>\$ (0.48)</u>	<u>\$ (0.60)</u>
Diluted	<u>\$ 0.01</u>	<u>\$ (0.20)</u>	<u>\$ (0.63)</u>	<u>\$ (0.15)</u>	<u>\$ (0.03)</u>	<u>\$ (0.48)</u>	<u>\$ (0.60)</u>
Weighted average number of shares outstanding:							
Basic	21,332	19,011	18,229	18,004	18,036	17,870	17,879
Diluted	23,468	19,011	18,229	18,004	18,036	17,870	17,879

	As of December 31,					As of March 31,
	2004	2003	2002	2001 (a)	2000 (Unaudited)	2001
<b>Consolidated Balance Sheet Data:</b>						
Working capital	\$ 22,608	\$ 21,407	\$ 16,045	\$11,189	\$ 21,055	\$ 19,941
Total assets	130,327	108,359	107,222	51,611	58,789	59,089
Long-term obligations	8,749	3,760	4,514	5,873	4,100	4,353
Shareholders' equity	29,926	28,417	26,470	36,605	39,010	37,001

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(a) In June 2001, we changed our fiscal year end from March 31 to December 31.

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### Item 7. *Management's Discussion and Analysis of Financial Condition and Results of Operations*

*We believe the following discussion and analysis provides information that is relevant to an assessment and understanding of our consolidated results of operations and financial condition. The discussion and analysis should be read in conjunction with the consolidated financial statements and related notes thereto appearing elsewhere in this Form 10-K. This Management's Discussion and Analysis will help you understand:*

- The impact of forward looking statements;
- Key transactions that we completed in 2004;
- Our financial structure, including our historical financial presentation;
- Our results of operations for the last three years;
- Our relationship with our subsidiary Supplies Distributors;
- Our liquidity and capital resources;
- The impact of seasonality, inflation and recently issued accounting standards on our financial statements; and
- Our critical accounting policies and estimates.

### Forward-Looking Information

We have made forward-looking statements in this Report on Form 10-K. These statements are subject to risks and uncertainties, and there can be no guarantee that these statements will prove to be correct. Forward-looking statements include assumptions as to how we may perform in the future. When we use words like “seek,” “strive,” “believe,” “expect,” “anticipate,” “predict,” “potential,” “continue,” “will,” “may,” “could,” “intend,” “plan,” “target” and “estimate” or similar expressions, we are making forward-looking statements. You should understand that the following important factors, in addition to those set forth above or elsewhere in this Report on Form 10-K, could cause our results to differ materially from those expressed in our forward-looking statements. These factors include:

- our ability to retain and expand relationships with existing clients and attract and implement new clients;
- our reliance on the fees generated by the transaction volume or product sales of our clients;
- our reliance on our clients’ projections or transaction volume or product sales;
- our dependence upon our agreements with IBM;
- our dependence upon our agreements with our major clients;
- our client mix, their business volumes and the seasonality of their business;
- our ability to finalize pending contracts;
- the impact of strategic alliances and acquisitions;
- trends in the market for our services;
- trends in e-commerce;
- whether we can continue and manage growth;
- changes in the trend toward outsourcing;
- increased competition;
- our ability to generate more revenue and achieve sustainable profitability;
- effects of changes in profit margins;
- the customer and supplier concentration of our business;

- the unknown effects of possible system failures and rapid changes in technology;
- trends in government regulation both foreign and domestic;
- foreign currency risks and other risks of operating in foreign countries;
- potential litigation;
- our dependency on key personnel;
- the impact of new accounting standards and rules regarding revenue recognition, stock options and other matters;
- changes in accounting rules or the interpretations of those rules;
- our ability to raise additional capital or obtain additional financing; and
- our ability or the ability of our subsidiaries to borrow under current financing arrangements and maintain compliance with debt covenants.

We have based these statements on our current expectations about future events. Although we believe that the expectations reflected in our forward-looking statements are reasonable, we cannot guarantee you that these expectations actually will be achieved. In addition, some forward-looking statements are based upon assumptions as to future events that may not prove to be accurate. Therefore, actual outcomes and results may differ materially from what is expected or forecasted in such forward-looking statements. We undertake no obligation to update publicly any forward-looking statement for any reason, even if new information becomes available or other events occur in the future. There may be additional risks that we do not currently view as material or that are not presently known. In evaluating these statements, you should consider various factors, including the risks set forth in the section entitled “Risk Factors.”

### Key Transactions in 2004

During 2004, we completed the following key transactions:

- We entered into new contracts with new and existing clients with estimated annual service fees of more than \$20 million based on current client projections. Service fee revenues invoiced from these new contracts in 2004 were approximately \$5.0 million. We also recognized approximately \$5.0 million of service fee revenue in 2004 from special projects with new and existing clients;
  - We began managing a 220,000 square feet facility in Grapevine, Texas under a new facility operation and management contractual relationship;
  - We entered into a new lease for an additional 602,000 square feet distribution facility in Southaven, Mississippi;
- We amended and extended our financing agreement with Comerica Bank to provide for up to \$5 million of available financing under a revolving working capital line of credit through 2007 and a \$2.5 million equipment line of credit through June 2008; and
- We issued \$5 million of taxable revenue bonds to finance a portion of our capital investments at our new distribution facility in Mississippi.

### Overview

We are an international provider of integrated business process outsourcing solutions to major brand name companies seeking to maximize their supply chain efficiencies and to extend their traditional business and e-commerce initiatives. We derive our revenues from a broad range of services, including professional consulting, technology collaboration, order management, managed web hosting and web development, customer relationship management, financial services including billing and collection services and working capital solutions, options kitting and assembly services, facilities and operations management, information management and international fulfillment and distribution services. We offer our services as an integrated solution, which enables our clients to outsource their complete infrastructure needs to a single source and to focus on their core competencies. Our distribution services are conducted at warehouses that we lease or manage and include real-time inventory management and customized picking, packing and shipping of our clients' customer orders. We offer the ability to provide infrastructure and distribution solutions to clients that operate in a range of vertical markets, including technology manufacturing, computer products, printers, cosmetics, fragile goods, high security collectibles, pharmaceuticals, contemporary home furnishings, apparel, aviation, telecommunications and consumer electronics, among others.

We provide these services, and earn our revenue, through two separate business segments, which have operationally similar business models. The first business segment is a service fee revenue model. In this segment, we do not own the underlying inventory or the resulting accounts receivable, but provide management services for these client-owned assets. We typically charge our service fee revenue on a cost-plus basis, a percent of shipped revenue basis or a per-transaction basis, such as a per-minute basis for web-enabled customer contact center services and a per-item basis for fulfillment services. Additional fees are billed for other services. We price our services based on a variety of factors, including the depth and complexity of the services provided, the amount of capital expenditures or systems customization required, the length of contract and other factors.

Many of our service fee contracts involve third-party vendors who provide additional services such as package delivery. The costs we are charged by these third-party vendors for these services are often passed on to our clients. Our billings for reimbursements of these and other 'out-of-pocket'



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expenses include travel, shipping and handling costs and telecommunication charges are included in pass through revenue.

Our second business segment is a product revenue model. In this segment, we are a master distributor of product for IBM and certain other clients. In this capacity, we purchase, and thus own, inventory and recognize the corresponding product revenue. As a result, upon the sale of inventory, we own the accounts receivable. Freight costs billed to customers are reflected as components of product revenue. This business segment requires significant working capital requirements, for which we have senior credit facilities to provide for up to approximately \$84 million of available financing.

For the periods subsequent to October 1, 2002, our services include purchasing and reselling client product inventory within this product revenue segment. In these arrangements, our product revenue is recognized at the time product is shipped. During this time, product revenue includes freight costs billed to customers and is reduced for pass through customer marketing programs. For the period prior to September 30, 2002, these IBM and other agreements were structured such that we provided transaction management services only on a service fee basis based on a percentage of shipped revenue. See “Historical Financial Presentation.”

Growth is a key element to us achieving our future goals, including maintaining sustainable profitability. Our growth is driven by two main elements: new client relationships and organic growth from existing clients. On an overall basis, we have experienced an increase in service fee revenues from existing clients and an increase in product revenues in recent years. During 2004, we were successful in winning new contracts with new and existing clients. Due to the length of the sales cycle and the time required to implement these new contracts, our 2004 results include approximately 25%, or approximately \$5 million, of what we believe will ultimately be the fully operational annual fee revenue under these contracts which is currently estimated at more than \$20 million. We expect to invoice more than 80% of the annual run-rate revenue of these new contracts during 2005.

Although our success with winning new contracts has recently improved, we continue to monitor and control our costs to focus on profitability. While we expect our new service fee contracts to yield increased gross profit, we expect this profit to be somewhat offset by incremental investments to implement new contracts, investments in infrastructure and sales and marketing to support our targeted growth and increased public company professional fees.

Our expenses comprise primarily four categories: 1) cost of product revenue, 2) cost of service fee revenue, 3) cost of pass-through revenue and 4) selling, general and administrative (“SG&A”) expenses.

*Cost of product revenue* - subsequent to October 1, 2002 cost of product revenue consists of the purchase price of product sold and freight costs, which are reduced by certain reimbursable expenses. These reimbursable expenses include pass-through customer marketing programs, direct costs incurred in passing on any price decreases offered by IBM to Supplies Distributors or its customers to cover price protection and certain special bids, the cost of products provided to replace defective product returned by customers and certain other expenses as defined under the master distributor agreements.

*Cost of service fee revenue* – consists primarily of compensation and related expenses for our Web-enabled customer contact center services, international fulfillment and distribution services and professional consulting services, and other fixed and variable expenses directly related to providing services under the terms of fee based contracts, including certain occupancy and information technology costs and depreciation and amortization expenses.

*Cost of pass-through revenue* –the related reimbursable costs for pass-through expenditures are reflected as cost of pass-through revenue.

*SG&A expenses* - consist primarily of compensation and related expenses for sales and marketing staff, executive, management and administrative personnel and other overhead costs, including certain occupancy and information technology costs and depreciation and amortization expenses. In addition, subsequent to October 1, 2002, certain direct contract costs related to our IBM and other master distributor agreements are reflected as selling and administrative expenses.

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Monitoring and controlling our available cash balances continues to be a primary focus. Our cash and liquidity positions are important components of our financing of both current operations and our targeted growth. In recent years we have added to our available cash and liquidity positions through various transactions. First we have a working capital financing agreement with a bank that currently provides financing for up to \$5 million of eligible accounts receivable and financing for up to \$2.5 million of eligible capital expenditures. Secondly, in 2003 we completed a private placement of approximately 1.6 million shares of our common stock to certain investors that provided net proceeds of approximately \$3.2 million. In January 2005, we issued an additional 0.4 million shares of common stock to certain of these investors who exercised warrants issued in the private placement. The warrants exercised provided \$1.3 million of additional proceeds. Thirdly, in 2004 we issued \$5 million of taxable revenue bonds to finance capital additions to our new facility in Southaven, MS.

### Historical Financial Presentation

We believe our historical financial statements may not provide a meaningful comparison to our current and future financial performance for the reasons described below.

Prior to our public offering in December 1999, we were a wholly-owned subsidiary of Daisytek International Corporation (“Daisytek”). We completed our separation from Daisytek on July 6, 2000 through a pro rata distribution to Daisytek’s common stockholders of all of the shares of our common stock that Daisytek then held.

The financial information presented for the year ended March 31, 2001 may not reflect what our results of operations, financial position and cash flows would have been had we been a separate, stand-alone entity during the period presented. This is because we made certain adjustments and allocations since Daisytek did not account for us as, and we were not operated as, a single stand-alone business for the period presented.

We cannot assure you that the adjustments and allocations we made in preparing our historical consolidated financial statements appropriately reflect our operations during such period as if we had, in fact, operated as a stand-alone entity or what the actual effect of our separation from Daisytek would have been. Accordingly, we cannot assure you that our historical results of operations are indicative of our future operating or financial performance.

The financial information presented for the periods prior to October 1, 2002 reflect our agreements with IBM and master distributors of certain IBM products (until July 2001 a Daisytek subsidiary, and from July 2001 until September 2002, Supplies Distributors, our 49% owned subsidiary). Under these agreements, the master distributors owned and distributed the IBM product and we provided transaction management and fulfillment services to the master distributors. Under these agreements, we did not own the IBM product and our revenue was service fee revenue (based on product sales volume or other transaction based pricing) and not product revenue.

In October 2002, we acquired the remaining 51% ownership interest in Supplies Distributors and we now consolidate 100% of Supplies Distributors financial position and results of operations into our consolidated financial statements. Upon consolidation, effective October 1, 2002, we own the IBM product and record product revenue as the product is sold to IBM customers.

As a result of consolidating Supplies Distributors’ financial position and results of operations, our total revenues arising under our new IBM agreements have increased, as compared to the total revenues arising under the prior IBM agreements. However, our gross profit margin as a percent of product revenue under the new IBM agreements is lower as compared to our gross profit margin as a percent of net service fee revenue under the prior IBM service fee agreements.

As a result of reflecting revenue earned under the master distributor agreements as product revenue in certain periods and as service fee revenue in others, our historical results of operations may not be indicative of our future operating or financial performance.

### Results of Operations

The following table sets forth certain historical financial information from our consolidated statements of operations expressed as a percent of net revenues.

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	Year Ended December 31		
	2004	2003	2002
Product revenue, net	83.1%	87.0%	59.3%
Service fee revenue	13.1	11.8	31.9
Service fee revenue, affiliate	—	—	5.0
Pass-through revenue	3.8	1.2	3.8
Total revenues	100.0	100.0	100.0
Cost of product revenue (as % of product revenue)	94.2	94.4	94.5
Cost of service fee revenue (as % of service fee revenue)	66.7	68.6	63.3
Cost of pass-through revenue (as % of pass-through revenue)	100.0	100.0	100.0
Total costs of revenues	90.8	91.4	83.2
Gross profit	9.2	8.6	16.8
Selling, general and administrative expenses	8.4	8.9	27.8
Severance and other termination costs	—	—	1.3
Asset and lease impairments	—	0.1	1.0
Income (loss) from operations	0.8	(0.4)	(13.3)
Equity in earnings of affiliate	—	—	1.2
Interest expense	0.5	0.7	1.0
Interest income	—	—	(0.8)%
Income (loss) before income taxes and extraordinary gain	0.3	(1.1)	(11.9)
Income tax expense (benefit)	0.2	0.2	0.1
Income (loss) before extraordinary gain	0.1	(1.3)	(12.0)
Extraordinary gain	—	—	0.2
Net income (loss)	0.1%	(1.3)%	(11.8)%

### Year Ended December 31, 2004 Compared to Year Ended December 31, 2003

**Product Revenue, Net.** Product revenue was \$267.5 million for the year ended December 31, 2004, as compared to \$249.2 million for the year ended December 31, 2003, an increase of \$18.3 million or 7.3%. The increase in annual product revenue resulted primarily from the favorable impact of exchange rates on our European and Canadian operations, increased sales volumes of certain existing products and the addition of certain new products.

**Service Fee Revenue.** Service fee revenue was \$42.1 million for the year ended December 31, 2004 as compared to \$33.7 million for the year ended December 31, 2003, an increase of \$8.4 million or 24.6%. Service fee revenue for the period included increased service fees generated from incremental projects with certain client relationships. The change in service fee revenue is shown below (\$ millions):

Year ended December 31, 2003	\$ 33.7
New service contract relationships, including projects	5.3
Increase in existing client service fees from organic growth and certain incremental projects	4.7
Terminated clients not included in 2004 revenue	(1.6)
Year ended December 31, 2004	\$ 42.1

Service fee revenue for the year ended December 31, 2004 included approximately \$1.0 million of fees earned from client contracts terminated during 2004.

**Cost of Product Revenue.** Cost of product revenue was \$252.0 million for the year ended December 31, 2004, as compared to \$235.3 million for the year ended December 31, 2003, an increase of \$16.7 million or 7.1%. Cost of product revenue as a percent of product revenue was 94.2% during the year ended December 31, 2004 and 94.4% during the year ended December 31, 2003. The increase in annual cost of product revenue from the prior year resulted primarily from the impact of exchange rates on our European and Canadian operations, increased sales volumes of certain existing products and the addition of certain new products partially offset by a reduction in our provision for excess and obsolete inventory. In both years, the cost of product revenue was also partially offset by other

inventory cost reductions from a vendor. The resulting gross profit margin was 5.8% and 5.6% for the year ended December 31, 2004 and 2003, respectively.

*Cost of Service Fee Revenue* . Cost of service fee revenue was \$28.1 million for the year ended December 31, 2004, as compared to \$23.2 million during the year ended December 31, 2003, an increase of \$4.9 million or 21.2%. The resulting service fee gross profit was \$14.0 million or 33.3% of service fee revenue, during the year ended December 31, 2004 as compared to \$10.6 million, or 31.4% of service fee revenue for the year ended December 31, 2003. Our gross profit as a percent of service fee revenue increased in the current period primarily due to incremental projects with certain client relationships partially offset by lower gross margins on certain new contracts, including certain start up costs. As we add new service fee revenue in the future, we currently intend to target the underlying contracts to earn an average gross profit percentage of 25-35%, but we have and may continue to accept lower gross margin percentages on certain contracts depending on contract scope and other factors.

*Selling, General and Administrative Expenses* . SG&A expenses were \$27.1 million for the year ended December 31, 2004 or 8.4% of total net revenues, as compared to \$25.4 million, or 8.9% of total revenues, for the year ended December 31, 2003. SG&A expenses increased from the prior year primarily due to additional expenses incurred in preparation of complying with the Sarbanes-Oxley Act of 2002 and incremental sales and marketing expenses. We expect SG&A expense to increase in calendar year 2005 due primarily to investments in infrastructure and sales and marketing expenses to support our targeted growth and professional fees primarily related to compliance with the requirements of the Sarbanes-Oxley Act.

*Interest Expense* . Interest expense was \$1.6 million for the year ended December 31, 2004 as compared to \$2.1 million for the year ended December 31, 2003. The decrease in interest expense is primarily due to lower average loan balances as a result of reduced inventory levels.

*Income Taxes* . For the years ended December 31, 2004 and 2003, we recorded a tax provision of \$0.7 million and \$0.6 million, respectively, primarily associated with Supplies Distributors' Canadian and European operations. We did not record an income tax benefit associated with our consolidated net loss in our U.S. operations. A valuation allowance has been provided for certain of our net deferred tax assets as of December 30, 2004, which are primarily related to our net operating loss carryforwards. We did not record an income tax benefit for our PFSweb European pre-tax losses in the current or prior periods. Due to the consolidation of Supplies Distributors, in the future we anticipate that we will continue to record an income tax provision associated with Supplies Distributors' Canadian and European results of operations.

#### ***Year Ended December 31, 2003 Compared to Year Ended December 31, 2002***

*Product Revenue*. Product revenue was \$249.2 million for the year ended December 31, 2003, as compared to \$57.5 million for the year ended December 31, 2002, which reflects product sales for Supplies Distributors subsequent to its consolidation effective October 1, 2002 (see "Supplies Distributors"). Supplies Distributors had \$163.6 million of product revenue for the nine months ended September 30, 2002 prior to consolidation, or a total of \$221.1 million of product revenue for the year ended December 31, 2002. The increase in annual product revenue resulted primarily from the favorable impact of exchange rates on our European and Canadian operations and increased sales volumes of many existing products. In addition, product revenue was favorably impacted by the addition of certain new products and increased sales prices for certain products.

*Service Fee Revenue (including service fee revenue, affiliate)* . Service fee revenue was \$33.8 million for the year ended December 31, 2003 as compared to \$35.8 million for the year ended December 31, 2002, a decrease of \$2.0 million or 5.7%. The change in service fee revenue is shown below (\$ millions):

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Year ended December 31, 2002	\$ 35.8
New service contract relationships	0.2
Increase in existing client service fees from organic growth and certain incremental projects	3.7
Elimination of service fees earned from our affiliate, Supplies Distributors	(4.7)
Terminated clients not included in 2003 revenue	(1.2)
Year ended December 31, 2003	<u>\$ 33.8</u>

Service fee revenue for the year ended December 31, 2003 included approximately \$0.9 million of fees earned from client contracts terminated during 2003.

*Cost of Product Revenue.* Cost of product revenue was \$235.3 million for the year ended December 31, 2003, as compared to \$54.3 million for the year ended December 31, 2002, which reflects cost of product sales for Supplies Distributors subsequent to its consolidation effective October 1, 2002. Cost of product revenue as a percent of product revenue was 94.4% during the year ended December 31, 2003 and 94.5% during the year ended December 31, 2002. Supplies Distributors had \$154.3 million of cost of product revenue, prior to consolidation, or a total of \$208.6 million of cost of product revenue for the year ended December 31, 2002. Annual cost of product revenue increased from the prior year from the impact of exchange rates on our European and Canadian operations, increased volumes of many existing products, the addition of certain new products and additional reserves for inventory impairment for the year ended December 31, 2003. The impact of these increases and additional reserves were partially offset by other inventory cost reductions from a vendor. The resulting gross profit margin was 5.6% and 5.5% for the year ended December 31, 2003 and the three months ended December 31, 2002, respectively.

*Cost of Service Fee Revenue .* Cost of service fee revenue was \$23.2 million for the year ended December 31, 2003, as compared to \$22.7 million during the year ended December 31, 2002, an increase of \$0.5 million or 2.2%. The resulting service fee gross profit was \$10.6 million or 31.4% of service fee revenue, during the year ended December 31, 2003 as compared to \$13.2 million, or 36.7% of service fee revenue for the year ended December 31, 2002. Our gross profit as a percent of service fee revenue decreased in the current period primarily as a result of the elimination of the service fee revenue affiliate and resulting gross profit from services provided under our arrangements with Supplies Distributors due to our consolidation in October 2002.

*Selling, General and Administrative Expenses .* SG&A expenses were \$25.4 million for the year ended December 31, 2003 or 8.9% of total revenues, as compared to \$27.0 million, or 27.8% of total revenues, for the year ended December 31, 2002. SG&A expenses decreased from the prior year primarily due to certain restructuring actions, including personnel reductions, which occurred in September 2002. In addition, the prior year SG&A expense included certain incremental sales and marketing costs. These items were partially offset as due to the consolidation of Supplies Distributors, we now reclassify certain costs previously characterized as cost of service fee revenue to SG&A. SG&A expenses as a percentage of total net revenues decreased from the prior year due to the increase in total net revenues, resulting from the inclusion of product sales subsequent to the consolidation of Supplies Distributors effective October 1, 2002.

*Asset and Lease Impairments .* In December 2003, we relocated our Canadian operations within Toronto. In conjunction with this relocation, we recorded an impairment expense for an operating lease and the write-down of certain assets. For the year ended December 31, 2002, we recorded \$0.9 million of expense for asset impairment and abandonment charges. This charge relates to an older warehouse management system that was upgraded to a new system, as well as the disposition of certain other assets no longer used in the business.

*Equity in Earnings of Affiliate.* For the year ended December 31, 2002, we recorded \$1.2 million of equity in earnings of affiliate that represents our allocation of Supplies Distributors' earnings prior to October 1, 2002. Due to the consolidation of Supplies Distributors, effective October 1, 2002, we no longer report equity in earnings of affiliate, on a consolidated basis, for our ownership of Supplies Distributors.

*Interest Expense .* Interest expense was \$2.1 million for the year ended December 31, 2003 as compared to \$0.8 million for the year ended December 31, 2002. The increase in interest expense is due to the consolidation of Supplies Distributors, which, as a distributor, requires substantial borrowings to fund its working capital needs.

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*Interest Income* . Interest income was \$0.1 million for the year ended December 31, 2003 as compared to \$1.0 million for the year ended December 31, 2002. Effective October 1, 2002 we now report lower consolidated interest income resulting from the elimination of interest income from the subordinated note due to PFS from Supplies Distributors upon consolidating Supplies Distributors, which caused the reduction in interest income for the year ended December 31, 2003. Interest income decreased as compared to the year ended December 31, 2002 attributable to lower interest rates earned by our cash and cash equivalents and lower balances of cash and cash equivalents.

*Income Taxes* . For the years ended December 31, 2003 and 2002, we recorded a tax provision of \$0.6 million and \$0.1 million, respectively, primarily associated with Supplies Distributors' Canadian and European operations. We did not record an income tax benefit associated with our consolidated net loss in our U.S. operations or the net loss from our Canadian and European service fee segments. A valuation allowance has been provided for our net deferred tax assets as of December 31, 2003, which are primarily related to our net operating loss carryforwards.

### Supplies Distributors and Subsidiaries

Supplies Distributors and its subsidiaries act as master distributors of various IBM and other products and, pursuant to a transaction management services agreement between us and Supplies Distributors, we provide transaction management and fulfillment services to Supplies Distributors and its subsidiaries. Since October 2002, we have owned 100% of Supplies Distributors. In addition to our equity investment in Supplies Distributors, we have also provided Supplies Distributors with a subordinated loan that, as of December 31, 2004, had an outstanding balance of \$7.0 million.

Pursuant to the terms of our transaction management services agreement with Supplies Distributors, we earned service fees, which are reported as service fee revenue, affiliate in the accompanying consolidated financial statements (prior to the consolidation of Supplies Distributors' results of operations effective October 1, 2002), of approximately \$4.9 million.

Prior to the consolidation of Supplies Distributors' operating results effective October 1, 2002, we recorded our interest in Supplies Distributors' net income, which was allocated and distributed to the owners pursuant to the terms of Supplies Distributors' operating agreement, under the modified equity method, which resulted in us recording our allocated earnings of Supplies Distributors or 100% of Supplies Distributors' losses. As a result of our 100% ownership of Supplies Distributors, future earnings will be allocated and dividends will be paid 100% to PFSweb. In September 2003, Supplies Distributors paid us a \$0.6 million dividend. In September 2004 and December 2004, Supplies Distributors paid us a \$0.6 million and \$0.2 million dividend, respectively. Pursuant to the terms of its amended credit agreements, Supplies Distributors is currently restricted from paying cash dividends without the prior approval of its lenders. In addition, no distribution may be made if, after giving effect thereto, the net worth of Supplies Distributors would be less than \$1.0 million.

### Liquidity and Capital Resources

Net cash provided by operating activities was \$5.5 million for the year ended December 31, 2004 and primarily resulted from cash generated from operations along with increases in accounts payable and accrued expenses of \$15.1 million partially offset by an increase in accounts receivable of \$9.8 million, an increase in prepaid expenses and other current assets of \$5.8 million. Net cash provided by operating activities was \$1.3 million for the year ended December 31, 2003, and primarily resulted from cash generated from operations plus decreases in inventory of \$2.5 million and in prepaid expenses and other current assets of \$0.9 million partially offset by a decrease in accounts payable and accrued expenses of \$5.6 million. The December 31, 2004, accounts payable balance was higher than normal primarily due to the timing of invoice processing by one of our master distribution vendors. Net cash used in operating activities was \$15.0 million for the year ended December 31, 2002, and primarily resulted from cash used to fund operating losses and the net impact of increases in Supplies Distributors' inventories of \$8.1 million from October 1, 2002 to December 31, 2002 and accounts payable and accrued expenses of \$4.6 million, partially offset by decreases in accounts receivable of \$2.1 million and prepaid expenses and other current assets of \$1.6 million.

Net cash used in investing activities for the year ended December 31, 2004 totaled \$8.8 million, resulting from



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capital expenditures of \$7.7 million and an increase in restricted cash of \$1.1 million. The increase in restricted cash resulted primarily from Mississippi taxable bond proceeds that are restricted specifically for payment on capital additions or as repayment on the outstanding bonds. Net cash used in investing activities for the year ended December 31, 2003 totaled \$0.2 million, resulting from capital expenditures of \$2.0 million partially offset by a decrease in restricted cash of \$1.7 million. The decrease in restricted cash resulted from a refinancing of certain of our previous debt and lease balances to remove the associated letter of credit cash restrictions. Net cash provided by investing activities for the year ended December 31, 2002 totaled \$1.5 million, representing the net repayment of \$2.9 million by Supplies Distributors of our subordinated loan, which totaled \$8.8 million at September 30, 2002, but which is now eliminated due to the consolidation of Supplies Distributors, (see "Supplies Distributors and Subsidiaries") and net cash acquired in our acquisition of the remaining 51% interest of Supplies Distributors, offset by capital expenditures of \$1.8 million.

Capital expenditures have historically consisted primarily of additions to upgrade our management information systems and general expansion of our facilities, both domestic and foreign. We expect to incur capital expenditures to support new contracts and anticipated future growth opportunities. We anticipate that our total investment in upgrades and additions to facilities and information technology services for the upcoming twelve months will be approximately \$7 million to \$10 million, although additional capital expenditures may be necessary to support the infrastructure requirements of new clients. To maintain our current operating cash position, a portion of these expenditures may be financed through debt, operating or capital leases or additional equity. We may elect to modify or defer a portion of such anticipated investments in the event that we do not achieve the revenue necessary to support such investments.

Net cash provided by financing activities was approximately \$2.2 million for the year ended December 31, 2004, primarily representing \$3.3 million of proceeds from debt and \$0.5 million of proceeds from the issuance of common stock pursuant to our employee stock purchase and stock option programs partially offset by \$1.1 million of payments on our capital lease obligations. Net cash provided by financing activities was approximately \$5.2 million for the year ended December 31, 2003, primarily representing \$4.1 million of proceeds from the issuance of common stock pursuant to our employee stock purchase and stock option programs and the sale of 1,581,944 shares of our common stock to certain institutional investors in a private placement transaction and \$1.8 million of proceeds from debt partially offset by \$1.0 million of payments on our capital lease obligations. Net cash provided by financing activities was \$11.4 million for the year ended December 31, 2002, primarily representing \$11.3 million of proceeds from debt.

During the year ended December 31, 2004, our working capital increased to \$22.6 million from \$21.4 million at December 31, 2003 primarily as a result of cash flow from operations plus incremental debt, partially offset by capital expenditures. To obtain additional financing in the future, in addition to our current cash position, we plan to evaluate various financing alternatives including the sale of equity, utilizing capital or operating leases, borrowing under our own credit facility, or transferring a portion of our subordinated loan balances due from Supplies Distributors to third-parties. In conjunction with certain of these alternatives, we may be required to provide certain letters of credit to secure these arrangements. No assurances can be given that we will be successful in obtaining any additional financing or the terms thereof. We currently believe that our cash position, financing available under our credit facilities and funds generated from operations (including our anticipated revenue growth and/or cost reductions to offset lower than anticipated revenue growth) will satisfy our presently known operating cash needs, our working capital and capital expenditure requirements, our lease obligations, and additional subordinated loans to Supplies Distributors, if necessary, for at least the next twelve months.

The following is a schedule of our total contractual cash obligations, which is comprised of operating leases, debt, vendor financing and capital leases (including interest), as of December 31, 2004 (in millions):

Contractual Obligations	Payments Due By Period				
	Total	Less than 1 Year	1 - 3 Years	3 - 5 Years	More than 5 Years
Debt and vendor financing	\$ 63,744	\$ 58,127	\$ 1,617	\$ 1,600	\$ 2,400
Capital lease obligations	2,978	1,232	1,569	177	—
Operating leases	20,664	6,207	10,644	2,764	1,049
Total	<u>\$ 87,386</u>	<u>\$ 65,566</u>	<u>\$ 13,830</u>	<u>\$ 4,541</u>	<u>\$ 3,449</u>

In support of certain debt instruments and leases, as of December 31, 2004 and 2003, we had \$0.9 million and \$1.2 million, respectively, of cash restricted as collateral for letters of credit. These letters of credit expire at various dates through March 2007, the related debt and lease obligations termination dates. As of December 31, 2004 and 2003, we had \$2.5 million and \$0.8 million, respectively, of cash restricted for payment of capital expenditures or repayment to lenders. In addition, as described above, we have provided collateralized guarantees to secure the repayment of certain of Supplies Distributors' and its subsidiaries' credit facilities. Many of our debt facilities include both financial and non-financial covenants, and also include cross default provisions applicable to other agreements. To the extent we fail to comply with our debt covenants, including the monthly financial covenant requirements and our required level of stockholders' equity, and the lenders accelerate the repayment of the credit facility obligations, we would be required to repay all amounts outstanding thereunder. Any requirement to accelerate the repayment of the credit facility obligations would have a material adverse impact on our financial condition and results of operations. We can provide no assurance that we will have the financial ability to repay all of such obligations. As of December 31, 2004, we were in compliance with all debt covenants and we believe that we will maintain such compliance throughout calendar year 2005. Furthermore, we are obligated to repay any over-advance made to Supplies Distributors or its subsidiaries by its lenders, in the event that Supplies Distributors or its subsidiaries are unable to do so. We are also required to maintain a minimum subordinated loan to Supplies Distributors of \$7.0 million, as amended. We must seek lender approval to increase this amount to more than \$8.0 million. We do not have any other material financial commitments.

In the future, we may attempt to acquire other businesses or seek an equity or strategic partner to generate capital or expand our services or capabilities in connection with our efforts to grow our business. Acquisitions involve certain risks and uncertainties and may require additional financing. Therefore, we can give no assurance with respect to whether we will be successful in identifying businesses to acquire or an equity or strategic partner, whether we or they will be able to obtain financing to complete a transaction, or whether we or they will be successful in operating the acquired business.

Supplies Distributors has a short-term credit facility with IBM Credit LLC ("IBM Credit") and Supplies Distributors' European subsidiaries have a short-term credit facility with IBM Belgium Financial Services S.A. ("IBM Belgium") to finance their distribution of IBM products. We have provided a collateralized guaranty to secure the repayment of these credit facilities. As of December 31, 2004, the asset-based credit facilities provided financing for up to \$31.0 million through February 28, 2005 and up to \$27.5 million thereafter and up to 12.5 million Euros (approximately \$17.0 million) with IBM Credit and IBM Belgium, respectively. These agreements expire in March 2006.

Supplies Distributors also has a loan and security agreement with Congress Financial Corporation (Southwest) ("Congress") to provide financing for up to \$25 million of eligible accounts receivables in the United States and Canada. The Congress facility expires on the earlier of March 29, 2007 or the date on which the parties to the IBM master distributor agreement no longer operate under the terms of such agreement and/or IBM no longer supplies products pursuant to such agreement.

Supplies Distributors' European subsidiary has a factoring agreement with Fortis Commercial Finance N.V. ("Fortis") to provide factoring for up to 7.5 million Euros (approximately \$10.2 million) of eligible accounts receivables through March 2006. Borrowings under this agreement can be either cash advances or straight loans, as defined.

These credit facilities contain cross default provisions, various restrictions upon the ability of Supplies Distributors and its subsidiaries to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties, provide guarantees, make investments and loans, pledge assets, make changes to capital stock ownership structure and pay dividends, as well as financial covenants, such as cash flow from operations, annualized revenue to working capital, net profit after tax to revenue, minimum net worth and total liabilities to tangible net worth, as defined, and are secured by all of the assets of Supplies Distributors, as well as a collateralized guaranty of PFSweb. Additionally, we are required to maintain a subordinated loan to Supplies Distributors of no less than \$7.0 million, maintain restricted cash of less than \$5.0 million, are restricted with regard to transactions with related parties, indebtedness and changes to capital stock ownership structure and a minimum shareholders' equity of at least \$18.0 million. Furthermore, we are obligated to repay any over-advance made to



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Supplies Distributors or its subsidiaries under these facilities if they are unable to do so. We have also provided a guarantee of the obligations of Supplies Distributors and its subsidiaries to IBM, excluding the trade payables that are financed by IBM credit.

Our subsidiary, Priority Fulfillment Services, Inc. (“PFS”), has entered into a Loan and Security Agreement with Comerica Bank (“Comerica”), which provides for up to \$5.0 million of eligible accounts receivable financing through March 2007, and up to \$2.5 million of eligible equipment purchases through June 2008 (of which \$0.5 million is available at February 28, 2005). We entered this Agreement to supplement our existing cash position, and provide funding for our future operations, including our targeted growth. The Agreement contains cross default provisions, various restrictions upon our ability to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties, make investments and loans, pledge assets, make changes to capital stock ownership structure, as well as financial covenants of a minimum tangible net worth of \$20 million, as defined, and a minimum liquidity ratio, as defined. The agreement also limits our ability to increase the subordinated loan to Supplies Distributors to more than \$8.0 million without the lender’s approval. The agreement is secured by all of the assets of PFS, as well as a guarantee of PFSweb.

In 2004, to fulfill our obligations under certain new client relationships, we entered into a three-year operating lease arrangement for a new distribution facility in Southaven, MS, near our existing distribution complex in Memphis, TN. Additionally, we incurred additional capital expenditures during 2004, primarily to support the incremental business in this new distribution center. Upon completion, which is expected to occur during the first and second quarters of 2005, we expect the total capital expenditures to support this facility will total approximately \$6 million. We financed a significant portion of these expenditures via the issuance of \$5 million of Mississippi taxable revenue bonds.

On November 7, 2003, we entered into a Securities Purchase Agreement with certain institutional investors in a private placement transaction pursuant to which we issued and sold an aggregate of 1.6 million shares of our common stock, par value \$.001 per share (the “Common Stock”), at \$2.16 per share, resulting in gross proceeds of \$3.4 million. After deducting expenses, the net proceeds were approximately \$3.2 million. In addition to the Common Stock, the investors received one-year warrants to purchase an aggregate 525,692 shares of Common Stock at an exercise price of \$3.25 per share and four-year warrants to purchase an aggregate of 395,486 shares of Common Stock at an exercise price of \$3.30 per share. In January 2005, 394,865 of the one-year warrants were exercised prior to their expiration, generating net proceeds to us of \$1.3 million. We intend to use the net proceeds from the private placement and warrant exercises for general working capital purposes.

On December 29, 2004, we entered into a Loan Agreement with the Mississippi Business Finance Corporation (the “MBFC”) in connection with the issuance by the MBFC of \$5 million MBFC Taxable Variable Rate Demand Limited Obligation Revenue Bonds, Series 2004 (Priority Fulfillment Services, Inc. Project) (the “Bonds”). The MBFC loaned us the proceeds of the Bonds for the purpose of financing the acquisition and installation of equipment, machinery and related assets located in our new Southaven, Mississippi distribution facility. The primary source of repayment of the Bonds is a letter of credit (the “Letter of Credit”) in the initial face amount of \$5.1 million issued by Comerica pursuant to a Reimbursement Agreement between us and Comerica under which we are obligated to pay to Comerica all amounts drawn under the Letter of Credit. The Letter of Credit has an initial maturity date of December 2006 at which time, if not renewed or replaced, will result in a draw on the undrawn face amount thereof.

## Inventory Management

We manage our inventories held for sale by maintaining sufficient quantities of product to achieve high order fill rates while at the same time maximizing inventory turnover rates. Inventory balances will fluctuate as we add new product lines. To reduce the risk of loss due to supplier price reductions, our master distributor agreement provides for price protection under which we receive credits if the supplier lowers prices on previously purchased inventory.

## Seasonality

The seasonality of our business is dependent upon the seasonality of our clients’ business and the sale of their products. Accordingly, our management must rely upon the projections of our clients in assessing quarterly

variability. We believe that with our current client mix and their current business volumes our service fee business activity will be at its lowest in the quarter ended March 31. However due to product release schedule changes from certain of our clients, we believe this seasonal impact will not be as significant in 2005 as it has been in prior years. We anticipate that our product revenue will be highest during the quarter ended December 31.

We believe that results of operations for a quarterly period may not be indicative of the results for any other quarter or for the full year.

### **Inflation**

Management believes that inflation has not had a material effect on our operations.

### **Impact of Recently Issued Accounting Standards**

In December 2004, the FASB issued SFAS No. 123 (revised 2004), *Share-Based Payment* ("SFAS 123R"), which replaces SFAS No. 123, *Accounting for Stock-Based Compensation*, ("SFAS 123") and supercedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*. SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values beginning with the first interim or annual period after June 15, 2005, with early adoption encouraged. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. We are required to adopt SFAS 123R in the third quarter of fiscal 2005, beginning July 1, 2005. Under SFAS 123R, we must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at date of adoption. The transition methods include prospective and retroactive adoption options. Under the retroactive option, prior periods may be restated either as of the beginning of the year of adoption or for all periods presented. The prospective method requires that compensation expense be recorded for all unvested stock options and restricted stock at the beginning of the first quarter of adoption of SFAS 123R, while the retroactive methods would record compensation expense for all unvested stock options and restricted stock beginning with the first period restated. We are evaluating the requirements of SFAS 123R and expect that the adoption of SFAS 123R will have a material impact on our consolidated results of operations and earnings per share. We have not yet determined the method of adoption or the effect of adopting SFAS 123R, and have not determined whether the adoption will result in amounts that are similar to the current pro forma disclosures under SFAS 123.

### **Critical Accounting Policies and Estimates**

Our consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the U.S. These accounting principles require us to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of our financial statements and the reported amounts of revenues and expenses during the reporting period. While we do not believe the reported amounts would be materially different, application of these policies involves the exercise of judgment and the use of assumptions as to future uncertainties and, as a result, actual results could differ from these estimates. If there is a significant unfavorable change to current conditions, it would likely result in a material adverse impact to our business, operating results and financial condition. We evaluate our estimates and assumptions on an ongoing basis. We base our estimates on experience and on various other assumptions that we believe to be reasonable under the circumstances. All of our significant accounting policies are disclosed in the notes to our consolidated financial statements.

We have defined a critical accounting estimate as one that is both important to the portrayal of our financial condition and results of operations and requires us to make difficult, subjective or complex judgments or estimates about matters that are uncertain. During the past three fiscal years, we have not made any material changes in accounting methodology used to establish the critical accounting estimates discussed below, unless otherwise noted. All of our significant accounting policies are disclosed in the notes to our consolidated financial statements. The following represent certain critical accounting policies that require us to exercise our business judgment or make significant estimates. In addition, there are other items within our consolidated financial statements that require estimation but are not deemed critical as defined above.

***Cost of Service Fee Revenue***

Our service fee revenues primarily relate to our distribution services and order management/customer care services. Distribution services relate primarily to inventory management, product receiving, warehousing and fulfillment (i.e., picking, packing and shipping). Order management/customer care services relate primarily to taking customer orders for our client's products via various channels such as telephone call-center, electronic or facsimile. These services also entail addressing customer questions related to orders, as well as cross-selling/up-selling activities.

Our cost of service fee revenue represents the cost to provide the services described above, primarily compensation and related expenses and other fixed and variable expenses directly related to providing the services. These include certain occupancy and information technology costs and depreciation and amortization expenses. Certain of these costs are allocated from general and administrative expenses. For these allocations, we estimate the amount of direct expenses based on a client-specific number of transactions processed. We believe our allocation methodology is reasonable, however a change in assumptions would result in a different gross profit in our statement of operations, yet no change to the resulting net income or loss.

***Allowance for Doubtful Accounts***

The determination of the collectibility of amounts due from our customers requires us to use estimates and make judgments regarding future events and trends, including monitoring our customers' payment history and current credit worthiness to determine that collectibility is reasonably assured, as well as consideration of the overall business climate in which our customers operate. Inherently, these uncertainties require us to make frequent judgments and estimates regarding our customers' ability to pay amounts due us to determine the appropriate amount of valuation allowances required for doubtful accounts. Provisions for doubtful accounts are recorded when it becomes evident that the customer will not make the required payments at either contractual due dates or in the future. At December 31, 2004 and 2003, reserves for doubtful accounts totaled \$0.5 million and \$0.3 million, respectively. We believe that our reserve for doubtful accounts is adequate to cover anticipated losses under current conditions; however, uncertainties regarding changes in the financial condition of our customers, either adverse or positive, could impact the amount and timing of any additional provisions for doubtful accounts that may be required.

***Inventory Reserves***

Inventories (merchandise, held for resale, all of which are finished goods) are stated at the lower of weighted average cost or market. Supplies Distributors and its subsidiaries assume responsibility for slow-moving inventory under certain master distributor agreements, subject to certain termination rights, but have the right to return product rendered obsolete by engineering changes, as defined. We review inventory for impairment on a periodic basis, but at a minimum, annually. Recoverability of the inventory on hand is measured by comparison of the carrying value of the inventory to the fair value of the inventory. This requires us to record provisions and maintain reserves for excess or obsolete inventory. To determine these reserve amounts, we regularly review inventory quantities on hand and compare them to estimates of future product demand and market conditions. These estimates and forecasts inherently include uncertainties and require us to make judgments regarding potential outcomes. At December 31, 2004 and 2003, our allowance for slow moving inventory totaled \$2.5 million and \$1.3 million, respectively. We believe that our reserves are adequate to cover anticipated losses under current conditions. Significant or unanticipated changes to our estimates and forecasts, either adverse or positive, could impact the amount and timing of any additional provisions for excess or obsolete inventory that may be required.

***Income Taxes***

The liability method is used for determining our income taxes, under which current and deferred tax liabilities and assets are recorded in accordance with enacted tax laws and rates. Under this method, the amounts of deferred tax liabilities and assets at the end of each period are determined using the tax rate expected to be in effect when taxes are actually paid or recovered. Valuation allowances are established to reduce deferred tax assets when it is more likely than not that some portion or all of the deferred tax assets will not be realized. In determining the need for valuation allowances, we have considered and made judgments and estimates regarding estimated future taxable income. These estimates and judgments include some degree of uncertainty and changes in these estimates and

assumptions could require us to adjust the valuation allowances for our deferred tax assets. The ultimate realization of the certain of our deferred tax assets depends on the generation of sufficient taxable income in the applicable taxing jurisdictions. Although we believe our estimates and judgments are reasonable, actual results may differ, which could be material.

As we operate in multiple countries, we are subject to the jurisdiction of multiple domestic and foreign tax authorities. Determination of taxable income in any jurisdiction requires the interpretation of the related tax laws and regulations and the use of estimates and assumptions regarding significant future events such as the amount, timing and character of deductions, permissible revenue recognition methods under the tax law and the sources and character of income and tax credits. Changes in tax laws, regulations, foreign currency exchange restrictions or our level of operations or profitability in each taxing jurisdiction could have an impact on the amount of income taxes that we provide during any given year.

### *Capitalized Software*

Our capitalized software includes internal and external costs incurred in developing or obtaining computer software for internal use and to implement new or expanded client relationships. We make judgments to determine if each project will satisfy its intended use. Additionally, we estimate the average internal costs incurred for payroll related benefits for the employees who directly devote time relating to the design, development and testing phase of the project. On an ongoing basis, we perform an impairment analysis on various technologies. If the carrying value of the various technologies exceeds the fair value, impairment charges are recorded.

### *Long-Lived Assets*

Long-lived assets include property, intangible assets and certain other assets. We make judgments and estimates in conjunction with the carrying value of these assets, including amounts to be capitalized, depreciation and amortization methods and useful lives. Additionally, we review long-lived assets for impairment periodically or whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. We record impairment losses in the period in which we determine that the carrying amount is not recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. This may require us to make judgments regarding long-term forecasts of our future revenues and costs related to the assets subject to review.

### *Self Insurance*

We are self-insured for medical insurance benefits up to certain stop-loss limits. Each reporting period we record the costs, including paid claims, an estimate for the change in incurred but not reported (“IBNR”) claims and administrative fees as an expense in the consolidated statement of operations. We base the estimated IBNR claims upon both (i) a recent level of monthly paid claims; and (ii) historical lag information provided by claims administrators based on recent paid claims, to provide for those claims that have been incurred but not yet paid. We believe the use of recent claims activity is representative of incurred and paid trends during the reporting period. Using the historical lag information involves a significant level of judgment. Accordingly, an increase (or decrease) in the estimated IBNR liability would result in a corresponding decrease (or increase) to net income.

**Item 7a. *Quantitative and Qualitative Disclosure about Market Risk***

We are exposed to various market risks including interest rates on our financial instruments and foreign exchange rates.

**Interest Rate Risk**

Our interest rate risk is limited to our outstanding balances on our inventory and working capital financing agreements, loan and security agreement, taxable revenue bonds, and factoring agreement for the financing of inventory, accounts receivable and certain other receivables, which amounted to \$63.3 million at December 31, 2004. A 100 basis point movement in interest rates would result in approximately \$0.2 million annualized increase or decrease in interest expense based on the outstanding balance of these agreements at December 31, 2004.

**Foreign Exchange Risk**

Currently, our foreign currency exchange rate risk is primarily limited to the Canadian Dollar and the Euro. In the future, our foreign currency exchange risk may also include other currencies applicable to certain of our international operations. We have and may continue, from time to time, to employ derivative financial instruments to manage our exposure to fluctuations in foreign currency rates. To hedge our net investment and intercompany payable or receivable balances in foreign operations, we may enter into forward currency exchange contracts. We do not hold or issue derivative financial instruments for trading purposes or for speculative purposes.

Item 8. Financial Statements and Supplementary Data

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS AND  
FINANCIAL STATEMENT SCHEDULES

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders of  
PFSweb, Inc.:

We have audited the accompanying consolidated balance sheets of PFSweb, Inc. and subsidiaries as of December 31, 2004 and 2003, and the related consolidated statements of operations, shareholders' equity and comprehensive income (loss) and cash flows for each of the years in the three-year period ended December 31, 2004. In connection with our audits of the consolidated financial statements, we also have audited the accompanying financial statement schedules as of December 31, 2004 and 2003, and for each of the years in the three-year period ended December 31, 2004. These consolidated financial statements and financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and financial statement schedules based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of PFSweb, Inc. and subsidiaries as of December 31, 2004 and 2003, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2004, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedules as of December 31, 2004 and 2003, and for each of the years in the three-year period ended December 31, 2004, when considered in relation to the basic financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

KPMG LLP

Dallas, Texas  
February 17, 2005, except for Notes 3 and 4 as to which the date is March 29, 2005



**PFSWEB, INC. AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**  
(In thousands, except share data)

	<u>December 31, 2004</u>	<u>December 31, 2003</u>
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 13,592	\$ 14,743
Restricted cash	2,746	1,091
Accounts receivable, net of allowance for doubtful accounts of \$504 and \$339 at December 31, 2004 and 2003, respectively	41,565	30,877
Inventories, net	44,947	44,589
Other receivables	8,061	3,872
Prepaid expenses and other current assets	3,349	2,417
Total current assets	<u>114,260</u>	<u>97,589</u>
PROPERTY AND EQUIPMENT, net	14,264	9,589
RESTRICTED CASH	675	900
OTHER ASSETS	<u>1,128</u>	<u>281</u>
Total assets	<u>\$ 130,327</u>	<u>\$ 108,359</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Current portion of long-term debt and capital lease obligations	\$ 19,098	\$ 19,533
Trade accounts payable	61,583	49,548
Accrued expenses	10,971	7,101
Total current liabilities	<u>91,652</u>	<u>76,182</u>
LONG-TERM DEBT AND CAPITAL LEASE OBLIGATIONS, less current portion	7,232	2,762
OTHER LIABILITIES	1,517	998
COMMITMENTS AND CONTINGENCIES		
<b>SHAREHOLDERS' EQUITY:</b>		
Preferred stock, \$1.00 par value; 1,000,000 shares authorized; none issued and outstanding	—	—
Common stock, \$0.001 par value; 40,000,000 shares authorized; 21,665,585 and 21,247,941 shares issued at December 31, 2004 and 2003, respectively; and 21,579,285 and 21,161,641 outstanding at December 31, 2004 and 2003, respectively	22	21
Additional paid-in capital	56,645	56,156
Accumulated deficit	(29,077)	(29,303)
Accumulated other comprehensive income	2,421	1,628
Treasury stock at cost, 86,300 shares	(85)	(85)
Total shareholders' equity	<u>29,926</u>	<u>28,417</u>
Total liabilities and shareholders' equity	<u>\$ 130,327</u>	<u>\$ 108,359</u>

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

**PFSWEB, INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF OPERATIONS  
FOR THE YEARS ENDED DECEMBER 31  
(In thousands, except per share data)**

	<u>2004</u>	<u>2003</u>	<u>2002</u>
REVENUES:			
Product revenue, net	\$267,470	\$249,230	\$ 57,492
Service fee revenue	42,076	33,771	31,094
Service fee revenue, affiliate	—	—	4,731
Pass-through revenue	12,119	3,435	3,692
Total revenues	<u>321,665</u>	<u>286,436</u>	<u>97,009</u>
COSTS OF REVENUES:			
Cost of product revenue	251,968	235,317	54,343
Cost of service fee revenue	28,067	23,159	22,660
Cost of pass-through revenue	12,119	3,435	3,692
Total costs of revenues	<u>292,154</u>	<u>261,911</u>	<u>80,695</u>
Gross profit	29,511	24,525	16,314
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES	27,091	25,442	27,012
SEVERANCE AND OTHER TERMINATION COSTS	—	—	1,213
ASSET AND LEASE IMPAIRMENTS	<u>—</u>	<u>257</u>	<u>922</u>
Income (loss) from operations	2,420	(1,174)	(12,833)
EQUITY IN EARNINGS OF AFFILIATE	—	—	1,163
INTEREST EXPENSE	1,590	2,124	816
INTEREST INCOME	<u>(130)</u>	<u>(124)</u>	<u>(977)</u>
Income (loss) before income taxes and extraordinary item	960	(3,174)	(11,509)
INCOME TAX EXPENSE	734	572	94
Income (loss) before extraordinary item	226	(3,746)	(11,603)
EXTRAORDINARY ITEM – gain on purchase of 51% share of Supplies Distributors	<u>—</u>	<u>—</u>	<u>203</u>
NET INCOME (LOSS)	<u>\$ 226</u>	<u>\$ (3,746)</u>	<u>\$(11,400)</u>
BASIC AND DILUTED EARNINGS (LOSS) PER SHARE:			
Income (loss) before extraordinary item	\$ 0.01	\$ (0.20)	\$ (0.64)
Extraordinary item – gain on purchase of 51% share of Supplies Distributors	<u>—</u>	<u>—</u>	<u>0.01</u>
Net income (loss)	<u>\$ 0.01</u>	<u>\$ (0.20)</u>	<u>\$ (0.63)</u>
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING:			
Basic	<u>21,332</u>	<u>19,011</u>	<u>18,229</u>
Diluted	<u>23,468</u>	<u>19,011</u>	<u>18,229</u>

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

**PFSWEB, INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY AND  
COMPREHENSIVE INCOME (LOSS)**  
(In thousands, except share data)

	<u>Common Stock</u>		<u>Additional</u>	<u>Accumulated</u>	<u>Other</u>	<u>Treasury Stock</u>		<u>Total</u>	<u>Comprehensive</u>
	<u>Shares</u>	<u>Amount</u>	<u>Paid-In</u>	<u>Deficit</u>	<u>Comprehensive</u>	<u>Shares</u>	<u>Amount</u>	<u>Shareholders'</u>	<u>Income</u>
			<u>Capital</u>		<u>Income (Loss)</u>			<u>Equity</u>	<u>(Loss)</u>
Balance, December 31, 2001	18,143,409	\$ 18	\$ 51,942	\$ (14,157)	\$ (1,113)	86,300	\$ (85)	\$ 36,605	
Net loss	—	—	—	(11,400)	—	—	—	(11,400)	\$ (11,400)
Stock based compensation expense	—	—	28	—	—	—	—	28	
Employee stock purchase plan	254,574	—	124	—	—	—	—	124	
Other comprehensive income—foreign currency translation adjustment	—	—	—	—	1,113	—	—	1,113	1,113
Comprehensive loss									\$ (10,287)
Balance, December 31, 2002	18,397,983	\$ 18	\$ 52,094	\$ (25,557)	\$ —	86,300	\$ (85)	\$ 26,470	
Net loss	—	—	—	(3,746)	—	—	—	(3,746)	\$ (3,746)
Stock based compensation expense	—	—	6	—	—	—	—	6	
Employee stock purchase plan	618,446	1	261	—	—	—	—	262	
Proceeds from exercised options	649,568	1	618	—	—	—	—	619	
Private placement of common stock	1,581,944	1	3,177	—	—	—	—	3,178	
Other comprehensive income—foreign currency translation adjustment	—	—	—	—	1,628	—	—	1,628	1,628
Comprehensive loss									\$ (2,118)
Balance, December 31, 2003	21,247,941	\$ 21	\$ 56,156	\$ (29,303)	\$ 1,628	86,300	\$ (85)	\$ 28,417	
Net income	—	—	—	226	—	—	—	226	\$ 226
Stock based compensation expense	—	—	14	—	—	—	—	14	
Employee stock purchase plan	226,381	1	316	—	—	—	—	317	
Proceeds from exercised options	191,263	—	159	—	—	—	—	159	
Other comprehensive income—foreign currency translation adjustment	—	—	—	—	793	—	—	793	793
Comprehensive income									\$ 1,019
Balance, December 31, 2004	21,665,585	\$ 22	\$ 56,645	\$ (29,077)	\$ 2,421	86,300	\$ (85)	\$ 29,926	

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

**PFSWEB, INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR THE YEARS ENDED DECEMBER 31  
(In thousands)**

	<u>2004</u>	<u>2003</u>	<u>2002</u>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income (loss)	\$ 226	\$ (3,746)	\$ (11,400)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	4,643	4,497	5,851
Loss on disposition of assets	—	32	—
Asset and lease impairments	—	257	922
Extraordinary gain	—	—	(203)
Provision for doubtful accounts	289	351	38
Provision for excess and obsolete inventory	1,204	1,984	(10)
Deferred income taxes	(81)	(134)	(54)
Equity in earnings of affiliate	—	—	(1,163)
Non-cash compensation expense	14	6	28
Changes in operating assets and liabilities:			
Accounts receivables	(9,838)	173	2,087
Inventories, net	(318)	2,527	(8,110)
Prepaid expenses and other current assets, other receivables and other assets	(5,825)	896	1,628
Accounts payable, accrued expenses and other current and long-term liabilities	<u>15,149</u>	<u>(5,565)</u>	<u>(4,564)</u>
Net cash provided by (used in) operating activities	<u>5,463</u>	<u>1,278</u>	<u>(14,950)</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Purchases of property and equipment	(7,698)	(1,982)	(1,762)
Decrease (increase) in restricted cash	(1,071)	1,744	(156)
Cash acquired in acquisition of affiliate, net of cash paid	—	—	501
Proceeds from sale of distribution equipment	—	—	85
Proceeds from loans to affiliate, net	<u>—</u>	<u>—</u>	<u>2,855</u>
Net cash provided by (used in) investing activities	<u>(8,769)</u>	<u>(238)</u>	<u>1,523</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Net proceeds from issuance of common stock	475	4,059	124
Decrease (increase) in restricted cash	(359)	268	780
Payments on capital lease obligations	(1,134)	(954)	(862)
Proceeds from debt, net	<u>3,266</u>	<u>1,816</u>	<u>11,319</u>
Net cash provided by financing activities	<u>2,248</u>	<u>5,189</u>	<u>11,361</u>
<b>EFFECT OF EXCHANGE RATES ON CASH</b>	<u>(93)</u>	<u>(81)</u>	<u>(8)</u>
<b>NET INCREASE (DECREASE) IN CASH</b>	<u>(1,151)</u>	<u>6,148</u>	<u>(2,074)</u>
<b>CASH AND CASH EQUIVALENTS, beginning of period</b>	<u>14,743</u>	<u>8,595</u>	<u>10,669</u>
<b>CASH AND CASH EQUIVALENTS, end of period</b>	<u>\$ 13,592</u>	<u>\$ 14,743</u>	<u>\$ 8,595</u>
<b>SUPPLEMENTAL CASH FLOW INFORMATION</b>			
Non-cash investing and financing activities:			
Fixed assets acquired under capital leases	<u>\$ 1,330</u>	<u>\$ 538</u>	<u>\$ 848</u>

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

## PFSWEB, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### 1. Overview and Basis of Presentation

##### *PFSweb, Inc. Overview*

PFSweb, Inc. and its subsidiaries, including Supplies Distributors, Inc. are collectively referred to as the “Company;” “Supplies Distributors” refers to Supplies Distributors, Inc. and its subsidiaries; and “PFSweb” refers to PFSweb, Inc. and its subsidiaries excluding Supplies Distributors.

PFSweb is an international provider of integrated business process outsourcing services to major brand name companies seeking to maximize their supply chain efficiencies and to extend their traditional and e-commerce initiatives in the United States, Canada, and Europe. PFSweb offers such services as professional consulting, technology collaboration, managed web hosting and internet application development, order management, web-enabled customer contact centers, customer relationship management, financial services including billing and collection services and working capital solutions, information management, facilities and operations management, kitting and assembly services, and international fulfillment and distribution services.

##### *Supplies Distributors Overview*

Supplies Distributors, PFSweb and International Business Machines Corporation (“IBM”) entered into master distributor agreements whereby Supplies Distributors acts as a master distributor of various products, primarily IBM product. Pursuant to transaction management services agreements between PFSweb and Supplies Distributors, PFSweb provides transaction management and fulfillment services to Supplies Distributors.

Supplies Distributors has obtained certain financing (see Notes 3 and 4) that allows it to fund the working capital requirements for the sale of primarily IBM products. Pursuant to the transaction management services agreements, PFSweb provides to Supplies Distributors such services as managed web hosting and maintenance, procurement support, web-enabled customer contact center services, customer relationship management, financial services including billing and collection services, information management, and international distribution services. Additionally, IBM and Supplies Distributors have outsourced the product demand generation to Global Marketing Services, Inc. (“GMS”). Supplies Distributors, via arrangements with GMS and PFSweb, sells products in the United States, Canada and Europe.

All of the agreements between PFSweb and Supplies Distributors were made in the context of a related party relationship and were negotiated in the overall context of PFSweb’s and Supplies Distributors’ arrangement with IBM. Although management generally believes that the terms of these agreements are consistent with fair market values, there can be no assurance that the prices charged to or by each company under these arrangements are not higher or lower than the prices that may be charged by, or to, unaffiliated third parties for similar services.

##### *Basis of Presentation*

For the period prior to September 2002, PFSweb owned 49% of Supplies Distributors and as such the results of Supplies Distributors were not consolidated into the Company’s results. The Company’s allocation of Supplies Distributors’ net income (see Note 9) was presented in the consolidated statements of operations as equity in earnings of affiliate for year ended December 31, 2002 (through September 30, 2002). Effective October 1, 2002, PFSweb purchased the remaining 51% interest in Supplies Distributors. As a result of the purchase, effective October 1, 2002, the Company began consolidating 100% of Supplies Distributors’ financial position and results of operations into the Company’s consolidated financial statements.

#### 2. Significant Accounting Policies

##### *Principles of Consolidation*

All intercompany accounts and transactions have been eliminated in consolidation. Accounts and transactions

**PFSWEB, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (continued)**

between PFSweb and Supplies Distributors have been eliminated as of December 31, 2004 and 2003 and for the years ended December 31, 2004 and 2003, and the three-month period ended December 31, 2002 (see Note 1).

***Investment in Affiliate***

In July 2001, PFSweb purchased a 49% investment in Supplies Distributors (see Note 9). Effective October 1, 2002, PFSweb purchased the remaining 51% ownership interest of Supplies Distributors. Prior to consolidating Supplies Distributors' financial position and results of operations, PFSweb recorded its interest in Supplies Distributors' net income, which was allocated and distributed to the owners pursuant to the terms of an operating agreement, under the modified equity method, which resulted in PFSweb recording its allocated earnings of Supplies Distributors or 100% of Supplies Distributors' losses.

In addition to the equity investment, PFSweb loaned Supplies Distributors monies in the form of a Subordinated Demand Note (the "Subordinated Note"). Under the terms of certain of the Company's debt facilities, the outstanding balance of the Subordinated Note cannot be increased to more than \$8.0 million or decreased to lower than \$7.0 million without prior approval of the Company's lenders (see Notes 3 and 4). As of December 31, 2004 and 2003, the outstanding balance of the Subordinated Note, which is eliminated upon the consolidation of Supplies Distributors' financial position, was \$7.0 million and \$8.0 million, respectively.

***Use of Estimates***

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the U.S. requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statement and the reported amounts of revenues and expenses during the reporting period. The recognition and allocation of certain operating expenses in these consolidated financial statements also require management estimates and assumptions. The Company's estimates and assumptions are continually evaluated based on available information and experience. Because the use of estimates is inherent in the financial reporting process, actual results could differ from estimates.

***Revenue and Cost Recognition***

Depending on the terms of the customer arrangement, the Company recognizes product revenue and product cost either upon the shipment of product to customers or when the customer receives the product. The Company permits its customers to return product for credit against other purchases, including defective products (that the Company then returns to the manufacturer) and incorrect shipments. The Company provides a reserve for estimated returns and allowances. The Company offers terms to its customers that it believes are standard for its industry.

Freight costs billed to customers are reflected as components of product revenues. Freight costs incurred by the Company are recorded as a component of cost of goods sold.

Under the master distributor agreements (see Note 6), the Company bills IBM for reimbursements of certain expenses, including: pass through customer marketing programs, including rebates and coop funds; certain freight costs; direct costs incurred in passing on any price decreases offered by IBM to Supplies Distributors or its customers to cover price protection and certain special bids; the cost of products provided to replace defective product returned by customers; and certain other expenses as defined. The Company records a receivable for these reimbursable amounts as they are incurred with a corresponding reduction in either inventory or cost of product revenue. The Company also reflects pass through customer marketing programs as a reduction of product revenue.

The Company's service fee revenues primarily relate to its (1) distribution services, (2) order management/customer care services and (3) the reimbursement of out-of-pocket and third-party expenses. The Company typically charges its service fee revenue on a cost-plus basis, a percent of shipped revenue basis or a per transaction basis, such as a per item basis for fulfillment services or a per minute basis for web-enabled customer contact center services. Additional fees are billed for other services.

Distribution services relate primarily to inventory management, product receiving, warehousing and fulfillment (i.e., picking, packing and shipping) and facilities and operations management. Service fee revenue for these

## PFSWEB, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (continued)

activities is recognized as earned, which is either (i) on a per transaction basis or (ii) at the time of product fulfillment, which occurs at the completion of the distribution services.

Order management/customer care services relate primarily to taking customer orders for the Company's client's products via various channels such as telephone call-center, electronic or facsimile. These services also entail addressing customer questions related to orders, as well as cross-selling/up-selling activities. Service fee revenue for this activity is recognized as the services are rendered. Fees charged to the client are on a per transaction basis based on either (i) a pre-determined fee per order or fee per telephone minutes incurred, or (ii) are included in the product fulfillment service fees that are recognized on product shipment.

The Company's billings for reimbursement of out-of-pocket expenses, including travel and certain third-party vendor expenses such as shipping and handling costs and telecommunication charges are included in pass-through revenue. The related reimbursable costs are reflected as cost of pass-through revenue.

The Company's cost of service fee revenue, representing the cost to provide the services described above, is recognized as incurred. Cost of service fee revenue also includes certain costs associated with technology collaboration and ongoing technology support that include creative internet application development and maintenance, web hosting, technology interfacing, and other ongoing programming activities. These activities are primarily performed to support the distribution and order management/customer care services and are recognized as incurred.

The Company also performs billing services and information management services for certain of its clients. Billing services and information management services are not always billed separately to clients because while the activities are continually performed, the costs may be insignificant and covered by other fees described above. If billed separately, the fees are recognized as the services are performed. If not billed separately, any revenue attributable to these services is included in the distribution or order management fees that are recognized as services are performed. The service fee revenue associated with these activities not billed separately are currently not significant and are incidental to the above-mentioned services.

The Company recognizes revenue, and records trade accounts receivables, pursuant to the methods described above, when collectibility is reasonably assured. Collectibility is evaluated on an individual customer basis taking into consideration historical payment trends, current financial position, results of independent credit evaluations and payment terms.

The Company primarily performs its services under one to three-year contracts that can generally be terminated by either party. In conjunction with these long-term contracts, the Company sometimes receives start-up fees to cover its implementation costs, including certain technology infrastructure and development costs. The Company defers the fees received, and the related costs, and amortizes them over the life of the contract. The amortization of deferred revenue is included as a component of service fee revenue. The amortization of deferred implementation costs is included as a cost of service fee revenue. To the extent implementation costs for non-technology infrastructure and development exceed the fees received, the excess costs are expensed as incurred. The following summarizes the deferred implementation revenues and costs, excluding technology and development costs, which are included in property and equipment (in thousands):

	December 31, 2004	December 31, 2003
Deferred implementation costs		
Current	\$ 507	\$ 204
Non-current	658	26
	<u>\$ 1,165</u>	<u>\$ 230</u>
Deferred implementation revenues		
Current	898	466
Non-current	821	87
	<u>\$ 1,791</u>	<u>\$ 553</u>

Current and non-current deferred implementation costs are a component of prepaid expenses and other assets, respectively. Current and non-current deferred implementation revenues, which may precede the timing of when the



**PFSWEB, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (continued)**

related implementation costs are incurred and thus deferred, are a component of accrued expenses and other liabilities, respectively.

***Concentration of Business and Credit Risk***

The Company's product revenue is primarily generated by sales of product purchased under master distributor agreements with one supplier.

Sales to two customers accounted for approximately 12% and 11% of the Company's total product revenues for the year ended December 31, 2004. Service fee revenue from two clients accounted for approximately 42% and 15% of service fee revenue for year ended December 31, 2004. On a consolidated basis, one customer/client accounted for approximately 18% of the Company's total revenues for the year ended December 31, 2004. As of December 31, 2004, two customers/clients accounted for approximately 27% of accounts receivable.

Sales to three customers accounted for approximately 13%, 12% and 10% of the Company's total product revenues for the year ended December 31, 2003. Service fee revenue from two clients accounted for approximately 40% and 16% of service fee revenue for year ended December 31, 2003. On a consolidated basis, two customers/clients accounted for approximately 16% and 10% of the Company's total revenues for the year ended December 31, 2003. As of December 31, 2003, two customers/clients accounted for approximately 37% of accounts receivable.

Sales to two customers accounted for approximately 13% and 12% of the Company's total product revenues for the year ended December 31, 2002. Service fee revenue from two clients accounted for approximately 35% and 14% of net service fee revenue for the year ended December 31, 2002. In addition, service fee revenue earned from Supplies Distributors prior to the October 1, 2002 acquisition date approximated 13% of net service fee revenue for the year ended December 31, 2002. On a consolidated basis, one customer/client accounted for approximately 21% of the Company's total revenues for the year ended December 31, 2002.

In conjunction with Supplies Distributors' financings, PFSweb has provided certain collateralized guarantees on behalf of Supplies Distributors. Supplies Distributors' ability to obtain financing on similar terms would be significantly impacted without these guarantees. Additionally, since Supplies Distributors has limited personnel and physical resources, its ability to conduct business could be materially impacted by contract terminations by GMS.

The Company has multiple arrangements with IBM and is dependent upon the continuation of such arrangements. These arrangements, which are critical to the Company's ongoing operations, include Supplies Distributors' and its subsidiaries' master distributor agreements, Supplies Distributors' and its subsidiaries' working capital financing agreements, product sales to IBM business units, a service fee relationship and a term master lease agreement.

***Cash and Cash Equivalents***

Cash equivalents are defined as short-term highly liquid investments with original maturities of three months or less.

***Restricted Cash***

Restricted cash includes the following items (in thousands):

	<b>December 31, 2004</b>	<b>December 31, 2003</b>
Current:		
Letters of credit security	\$ 225	\$ 260
Customer remittances	1,190	831
Bond financing	1,331	—
Total current	<u>2,746</u>	<u>1,091</u>
Long term:		
Letters of credit security	675	900
Total restricted cash	<u>\$ 3,421</u>	<u>\$ 1,991</u>

**PFSWEB, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (continued)**

The Company has cash restricted as collateral for letters of credit that secure certain debt and lease obligations (see Note 4). The letters of credit currently expire at various dates through March 2007.

In conjunction with certain of its financing agreements, Supplies Distributors has granted to its lenders a security interest in all customer remittances received in specified bank accounts (see Note 4). At December 31, 2004 and 2003, these bank accounts held \$1.2 million and \$0.8 million, respectively, which was restricted for payment to the lender against the outstanding debt.

At December 31, 2004, the Company has classified \$1.3 million of the proceeds from the issuance of Mississippi taxable revenue bonds (see Note 4) as restricted cash since the proceeds are restricted specifically for payment on capital expenditures or as payment on the outstanding bonds.

***Other Receivables and Liabilities***

Other receivables include \$7.9 million and \$3.8 million as of December 31, 2004 and 2003, respectively, for amounts due from IBM for billings under the master distributor agreements (see Note 6).

During 2001, the Company received a governmental grant for investments made in fixed assets in its Belgium operations. At establishment, the total grant of approximately \$1.6 million was deferred and is being recognized as a reduction in depreciation expense over the same period over which the related fixed assets are being depreciated. As of December 31, 2004 and 2003, a deferred credit of \$0.3 million at each year end and \$0.5 million and \$0.7 million, respectively, at each year end is included in accrued expenses and other liabilities, respectively, in the accompanying consolidated balance sheets and represents the unamortized portion of the grant. For the years ended December 31, 2004 and 2003 and 2002, approximately \$0.3 million, \$0.4 million and \$0.2 million, respectively, was recognized as a reduction of depreciation expense.

***Inventories***

Inventories (all of which are finished goods) are stated at the lower of weighted average cost or market. Supplies Distributors assumes responsibility for slow-moving inventory under certain master distributor agreements, subject to certain termination rights, but has the right to return product rendered obsolete by engineering changes, as defined (see Note 6). The Company reviews inventory for impairment on a periodic basis, but at a minimum, annually. Recoverability of the inventory on hand is measured by comparison of the carrying value of the inventory to the fair value of the inventory. During 2003, the Company agreed to certain modifications to a selected master distributor agreement. As a result of these modifications, the Company reevaluated its inventory for impairment during 2003, and increased its allowance for slow moving inventory. As of December 31, 2004 and 2003, the allowance for slow moving inventory was \$2.5 million and \$1.3 million, respectively.

In the event PFSweb, Supplies Distributors and IBM terminate the master distributor agreements, the agreements provide for the parties to mutually agree on a plan of disposition of Supplies Distributors' then existing inventory.

Inventories include merchandise in-transit that has not been received by the Company but that has been shipped and invoiced by Supplies Distributors' vendors. The corresponding payable for inventories in-transit is included in accounts payable in the accompanying consolidated financial statements.

***Property and Equipment***

The components of property and equipment as of December 31, 2004 and 2003 are as follows (in thousands):

**PFSWEB, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (continued)**

	<u>December 31,</u> <u>2004</u>	<u>December 31,</u> <u>2003</u>	<u>Depreciable Life</u>
Furniture and fixtures	\$ 9,996	\$ 9,255	2-10 years
Computer equipment	8,130	6,425	2-3 years
Leasehold improvements	6,044	5,401	2-9 years
Purchased and capitalized software costs	9,356	7,866	1-7 years
Other, primarily construction-in-progress	<u>3,982</u>	<u>28</u>	3-7 years
	37,508	28,975	
Less-accumulated depreciation and amortization	<u>(23,244)</u>	<u>(19,386)</u>	
Property and equipment, net	<u>\$ 14,264</u>	<u>\$ 9,589</u>	

Property and equipment are stated at cost and are depreciated using the straight-line method over the estimated useful lives of the respective assets. Leasehold improvements are amortized over the shorter of the useful life of the related asset or the remaining lease term.

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the assets exceeds the fair value of the assets. Fair value would be determined using appraisals, discounted cash flow analysis or similar valuation techniques. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

The Company's property held under capital leases amount to approximately \$3.0 million and \$3.1 million, net of accumulated amortization of approximately \$5.4 million and \$4.7 million, at December 31, 2004 and 2003, respectively.

***Foreign Currency Translation and Transactions***

For the Company's Canadian and European operations, the local currency is the functional currency. All assets and liabilities are translated at exchange rates in effect at the end of the period, and income and expense items are translated at the average exchange rates for the period.

The Company includes currency gains and losses on short-term intercompany advances in the determination of net income. Intercompany currency transaction gains and losses included in net income or loss were a net gain of \$0.2 million and \$0.3 million for the years ended December 31, 2004 and 2003, respectively. The Company will continue to report gains or losses on intercompany foreign currency transactions that are of a long-term investment nature as a separate component shareholders' equity.

***Stock Based Compensation***

The Company accounts for stock-based employee compensation plans using the intrinsic-value method as outlined under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ("APB No. 25") and related interpretations, including FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation and Interpretation of APB No. 25*, issued in March 2000 (see Note 5). The following table shows the pro forma effect on the Company's net income (loss) and income (loss) per share as if compensation cost had been recognized for stock-based employee compensation plans based on their fair value at the date of the grant. The pro forma effect of stock-based employee compensation plans on the Company's net income (loss) for those years may not be representative of the pro forma effect for future years due to the impact of vesting and potential future awards.

**PFSWEB, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (continued)**

	<u>Year Ended December 31, 2004</u>	<u>Year Ended December 31, 2003</u>	<u>Year Ended December 31, 2002</u>
	<u>(In thousands, except per share amounts)</u>		
Net income (loss) as reported	\$ 226	\$ (3,746)	\$ (11,400)
Add: Stock-based non-employee compensation expense included in reported net loss	14	6	28
Deduct: total stock-based employee and non-employee compensation expense determined under fair value based method	<u>(841)</u>	<u>(754)</u>	<u>(2,295)</u>
Pro forma net income (loss), applicable to common stock for basic and diluted computations	<u><u>\$ (601)</u></u>	<u><u>\$ (4,494)</u></u>	<u><u>\$ (13,667)</u></u>
Income (loss) per common share – basic and diluted			
As reported	<u><u>\$ 0.01</u></u>	<u><u>\$ (0.20)</u></u>	<u><u>\$ (0.63)</u></u>
Pro forma	<u><u>\$ (0.03)</u></u>	<u><u>\$ (0.24)</u></u>	<u><u>\$ (0.75)</u></u>

***Income Taxes***

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

***Self Insurance***

The Company is self-insured for medical insurance benefits up to certain stop-loss limits. Such costs are accrued based on known claims and an estimate of incurred, but not reported (“IBNR”) claims. IBNR claims are estimated using historical lag information and other data provided by claims administrators.

***Fair Value of Financial Instruments***

The carrying value of the Company’s financial instruments, which include cash and cash equivalents, accounts receivable, accounts payable and debt and capital lease obligations, approximate their fair values based on short terms to maturity or current market prices and interest rates.

***Comprehensive Income (Loss)***

Comprehensive income (loss) is defined as the change in equity (net assets) of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. Comprehensive income (loss) consists of net income (loss) and foreign currency translation adjustments.

***Net Income (Loss) Per Common Share***

Basic net income (loss) per share is computed by dividing net income (loss) available to common stockholders by the weighted average number of common shares outstanding for the reporting period. For the calculation of diluted net income per share for the year ended 2004, weighted average shares outstanding are increased by approximately 2.1 million shares, reflecting the dilutive effect of stock options. Stock options not included in the calculation of diluted net income (loss) per share for the years ended December 31, 2004, 2003 and 2002, were 0.7 million, 4.4 million, and 4.8 million, respectively, as the effect would be anti-dilutive. Warrants not included in the calculation of diluted net income (loss) per share for both of the years ended December 31, 2004 and 2003, were 0.9 million, as the effect would be anti-dilutive.

***Cash Paid During Year***

The Company made payments for interest of approximately \$1.7 million, \$1.9 million and \$0.8 million and income taxes of approximately \$0.6 million, \$0.5 million and \$0.8 million during the years ended December 31,

**PFSWEB, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (continued)**

2004, 2003, and 2002, respectively (see Notes 3, 4 and 10).

***Impact of Recently Issued Accounting Standards***

In December 2004, the FASB issued SFAS No. 123 (revised 2004), *Share-Based Payment* (“SFAS 123R”), which replaces SFAS No. 123, *Accounting for Stock-Based Compensation*, (“SFAS 123”) and supercedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*. SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values beginning with the first interim or annual period after June 15, 2005, with early adoption encouraged. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. The Company is required to adopt SFAS 123R in the third quarter of fiscal 2005, beginning July 1, 2005. Under SFAS 123R, the Company must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at date of adoption. The transition methods include prospective and retroactive adoption options. Under the retroactive option, prior periods may be restated either as of the beginning of the year of adoption or for all periods presented. The prospective method requires that compensation expense be recorded for all unvested stock options and restricted stock at the beginning of the first quarter of adoption of SFAS 123R while the retroactive methods would record compensation expense for all unvested stock options and restricted stock beginning with the first period restated. The Company is evaluating the requirements of SFAS 123R and expects that the adoption of SFAS 123R will have a material impact on the Company’s consolidated results of operations and earnings per share. The Company has not yet determined the method of adoption or the effect of adopting SFAS 123R, and it has not determined whether the adoption will result in amounts that are similar to the current pro forma disclosures under SFAS 123.

***Reclassifications***

Certain prior year data have been reclassified to conform to the current period presentation. These reclassifications had no effect on previously reported net income (loss) or shareholders’ equity.

**3. Vendor Financing:**

Outstanding obligations under vendor financing arrangements consist of the following (in thousands):

	<b>December 31, 2004</b>	<b>December 31, 2003</b>
Inventory and working capital financing agreements:		
United States	\$ 26,962	\$ 26,034
Europe	13,110	11,518
Total	<u>\$ 40,072</u>	<u>\$ 37,552</u>

***Inventory and Working Capital Financing Agreement, United States***

Supplies Distributors has a short-term credit facility with IBM Credit LLC to finance its distribution of IBM products in the United States, providing financing for eligible IBM inventory and for certain other receivables up to \$31.0 million through February 28, 2005 and up to \$27.5 million thereafter through its expiration on March 29, 2005. As of December 31, 2004, Supplies Distributors had \$3.3 million of available credit under this facility. The credit facility contains cross default provisions, various restrictions upon the ability of Supplies Distributors to, among others, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties, provide guarantees, make investments and loans, pledge assets, make changes to capital stock ownership structure and pay dividends, as well as financial covenants, such as annualized revenue to working capital, net profit after tax to revenue, and total liabilities to tangible net worth, as defined, and are secured by all of the assets of Supplies Distributors, as well as a collateralized guaranty of PFSweb. Additionally, PFSweb is required to maintain a minimum Subordinated Note receivable balance from Supplies Distributors of \$7.0 million and a minimum shareholders’ equity of \$18.0 million. Borrowings under the credit facility accrue interest, after a defined free financing period, at prime rate plus 1% (6% and 5% as of December 31, 2004 and 2003, respectively). The facility also includes a monthly service fee.

## PFSWEB, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (continued)

On March 29, 2005, Supplies Distributors entered into an amended credit facility with IBM Credit LLC, which extends the termination date through March 2006. The Company has classified the outstanding amounts under this facility as accounts payable in the consolidated balance sheets.

*Inventory and Working Capital Financing Agreement, Europe*

Supplies Distributors' European subsidiaries have a short-term credit facility with IBM Belgium Financial Services S.A. ("IBM Belgium") to finance their distribution of IBM products in Europe. The asset based credit facility with IBM Belgium provides up to 12.5 million Euros (approximately \$17.0 million) in financing for purchasing IBM inventory and for certain other receivables through March 29, 2005. As of December 31, 2004, Supplies Distributors' European subsidiaries had 2.4 million euros (\$3.3 million) of available credit under this facility. The credit facility contains cross default provisions, various restrictions upon the ability of Supplies Distributors and its European subsidiaries to, among others, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties, provide guarantees, make investments and loans, pledge assets, make changes to capital stock ownership structure and pay dividends, as well as financial covenants, such as annualized revenue to working capital, net profit after tax to revenue, and total liabilities to tangible net worth, as defined, and are secured by all of the assets of Supplies Distributors' European subsidiaries, as well as collateralized guaranties of Supplies Distributors and PFSweb. Additionally, PFSweb is required to maintain a minimum Subordinated Note receivable balance from Supplies Distributors of \$7.0 million and a minimum shareholders' equity of \$18.0 million. Borrowings under the credit facility accrue interest, after a defined free financing period, at Euribor plus 2.5% (4.7% and 3.5% as of December 31, 2004 and 2003, respectively). Supplies Distributors' European subsidiaries pay a monthly service fee on the commitment.

On March 29, 2005, Supplies Distributors' European subsidiaries entered into an amended credit facility with IBM Belgium, which extends the termination date through March 2006. The Company has classified the outstanding amounts under this facility that are collateralized by inventory as accounts payable in the consolidated balance sheets.

**4. Debt and Capital Lease Obligations:**

Outstanding obligations under debt and capital lease obligations consist of the following (in thousands):

	December 31, 2004	December 31, 2003
Loan and security agreements, United States		
Supplies Distributors	\$ 8,328	\$ 13,146
PFSweb	4,853	3,514
Factoring agreement, Europe	3,848	2,296
Taxable revenue bonds	5,000	—
Master lease agreements	3,141	3,080
Inventory and working capital financing agreement – Europe	682	8
Other	478	251
Total	26,330	22,295
Less current portion of long-term debt	19,098	19,533
Long-term debt, less current portion	<u>\$ 7,232</u>	<u>\$ 2,762</u>

*Loan and Security Agreement — Supplies Distributors*

Supplies Distributors has a loan and security agreement with Congress Financial Corporation (Southwest) ("Congress") to provide financing for up to \$25 million of eligible accounts receivable in the United States and Canada. As of December 31, 2004, Supplies Distributors had \$8.0 million of available credit under this agreement. The Congress facility expires on the earlier of March 29, 2007 or the date on which the parties to the IBM master distributor agreement no longer operate under the terms of such agreement and/or IBM no longer supplies products pursuant to such agreement. Borrowings under the Congress facility accrue interest at prime rate plus 0.00% to 0.25% or Eurodollar rate plus 2.25% to 2.75%, dependent on excess availability, as defined. The interest rate on outstanding borrowings at December 31, 2004 was 5.0%. This agreement contains cross default provisions, various restrictions



**PFSWEB, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (continued)**

upon the ability of and Supplies Distributors to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties, provide guarantees, make investments and loans, pledge assets, make changes to capital stock ownership structure and pay dividends, as well as financial covenants, such as minimum net worth, as defined, and is secured by all of the assets of Supplies Distributors, as well as a collateralized guaranty of PFSweb. Additionally, PFSweb is required to maintain a Subordinated Note receivable balance from Supplies Distributors of no less than \$6.5 million and restricted cash of less than \$5.0 million, and is restricted with regard to transactions with related parties, indebtedness and changes to capital stock ownership structure. Supplies Distributors has entered into blocked account agreements with its banks and Congress pursuant to which a security interest was granted to Congress for all customer remittances received in specified bank accounts. At December 31, 2004 and December 31, 2003, these bank accounts held \$1.2 million and \$0.8 million, respectively, which was restricted for payment to Congress.

***Loan and Security Agreement – PFSweb***

Priority Fulfillment Services, Inc. (the “Borrower”), a wholly-owned subsidiary of PFSweb, has a Loan and Security Agreement with Comerica Bank (“Comerica”), which was amended in December 2004 (“Comerica Agreement”). The Comerica Agreement provides for up to \$5.0 million of eligible accounts receivable financing (“Working Capital Advances”) through March 2, 2007, \$1.5 million of existing equipment financing and up to an additional \$1.0 million of eligible equipment purchases (collectively the “Equipment Advances”) through June 15, 2008. Outstanding Working Capital Advances, \$3.5 million as of December 31, 2004, accrue interest at prime rate plus 1% (6.25% as of December 31, 2004). Outstanding Equipment Advances, \$1.4 million as of December 31, 2004, accrue interest at prime rate plus 1.5% (6.75% as of December 31, 2004). As of December 31, 2004, the Borrower had \$1.4 million of available credit under the Working Capital Advance portion of this facility and \$1.0 million of available credit under the Equipment Advance portion of this facility. In January 2005, the Company repaid the \$3.5 million of Working Capital Advances outstanding as of December 31, 2004. The Comerica Agreement contains cross default provisions, various restrictions upon the Borrower’s ability to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties, make investments and loans, pledge assets, make changes to capital stock ownership structure, as well as financial covenants of a minimum tangible net worth of \$20 million, as defined, a minimum earnings before interest and taxes, plus depreciation, amortization and non-cash compensation accruals, if any, as defined, and a minimum liquidity ratio, as defined. The Comerica Agreement restricts the amount of the Subordinated Note to a maximum of \$8 million. The Comerica Agreement is secured by all of the assets of the Borrower, as well as a guarantee of PFSweb, Inc. The Comerica Agreement requires the Borrower to maintain a minimum cash balance of \$1.3 million at Comerica.

***Factoring Agreement***

Supplies Distributors’ European subsidiary has a factoring agreement with Fortis Commercial Finance N.V. (“Fortis”) to provide factoring for up to 7.5 million euros (approximately \$10.2 million) of eligible accounts receivables through March 2006. As of December 31, 2004, Supplies Distributors’ European subsidiary had approximately 2.3 million euros (\$3.1 million) of available credit under this agreement. Borrowings under this agreement can be either cash advances or straight loans, as defined. Cash advances accrue interest at 3.8% and straight loans accrue interest at Euribor plus 1.3%. As of December 31, 2004, there were no straight loans outstanding. This agreement contains various restrictions upon the ability of Supplies Distributors’ European subsidiary to, among other things, merge, consolidate and incur indebtedness, as well as financial covenants, such as minimum net worth. This agreement is secured by a guarantee of Supplies Distributors, up to a maximum of 200,000 euros.

***Taxable Revenue Bonds***

On December 29, 2004, PFSweb entered into a Loan Agreement with the Mississippi Business Finance Corporation (the “MBFC”) in connection with the issuance by the MBFC of \$5 million MBFC Taxable Variable Rate Demand Limited Obligation Revenue Bonds, Series 2004 (Priority Fulfillment Services, Inc. Project) (the “Bonds”). The MBFC loaned the proceeds of the Bonds to PFSweb for the purpose of financing the acquisition and installation of equipment, machinery and related assets located in the Company’s Southaven, Mississippi distribution facility. The Bonds bear interest at a variable rate (2.65% as of December 31, 2004), as determined by Comerica Securities, as Remarketing Agent. PFSweb, at its option, may convert the Bonds to a fixed rate, to be



**PFSWEB, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (continued)**

determined by the Remarketing Agent at the time of conversion.

The primary source of repayment of the Bonds is a letter of credit (the “Letter of Credit”) in the initial face amount of \$5.1 million issued by Comerica pursuant to a Reimbursement Agreement between PFSweb and Comerica under which PFSweb is obligated to pay to Comerica all amounts drawn under the Letter of Credit. The Letter of Credit has an initial maturity date of December 2006 at which time, if not renewed or replaced, will result in a draw on the undrawn face amount thereof.

***Debt Covenants***

To the extent the Company fails to comply with its covenants applicable to its debt or vendor financing obligations, including the monthly financial covenant requirements and required level of stockholders’ equity (\$20.0 million), and the lenders accelerate the repayment of the credit facility obligations, the Company would be required to repay all amounts outstanding thereunder. Any acceleration of the repayment of the credit facilities would have a material adverse impact on the Company’s financial condition and results of operations and no assurance can be given that the Company would have the financial ability to repay all of such obligations.

PFSweb has also provided a guarantee of the obligations of Supplies Distributors to IBM, excluding the trade payables that are financed by IBM credit.

***Master Lease Agreements***

The Company has a Term Lease Master Agreement with IBM Credit Corporation (“Master Lease Agreement”) that provides for leasing or financing transactions of equipment and other assets, which generally have terms of 3 to 5 years. The outstanding leasing transactions (\$1.2 million and \$0.1 million as of December 31, 2004 and 2003, respectively) are secured by the related equipment and letters of credit (see Note 2). The outstanding financing transactions (\$0.5 million and \$0.8 million as of December 31, 2004 and 2003, respectively) are secured by a letter of credit (see Note 2).

The Company has a master agreement with a leasing company that provided for leasing transactions of certain equipment. The amounts outstanding under this agreement as of December 31, 2004 and 2003 were \$1.2 million and \$1.5 million, respectively, and are secured by the related equipment.

The Company enters into other leasing and financing agreements as needed to finance the purchasing or leasing of certain equipment or other assets. Borrowings under these agreements are generally secured by the related equipment.

***Debt and Capital Lease Maturities***

The Company’s aggregate maturities of debt subsequent to December 31, 2004 are as follows (in thousands):

Fiscal year ended December 31,	
2005	\$ 18,055
2006	1,117
2007	500
2008	800
2009	800
Thereafter	2,400
Total	<u>\$ 23,672</u>

**PFSWEB, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (continued)**

The following is a schedule of the Company's future minimum lease payments under the capital leases together with the present value of the net minimum lease payments as of December 31, 2004 (in thousands):

Fiscal year ended December 31,	
2005	\$ 1,232
2006	995
2007	574
2008	177
Thereafter	—
Total minimum lease payments	\$ 2,978
Less amount representing interest at rates ranging from 5.75% to 18.0%	(320)
Present value of net minimum lease payments	2,658
Less: Current portion	(1,043)
Long-term capital lease obligations	<u>\$ 1,615</u>

**5. Stock and Stock Options**

***Preferred Stock Purchase Rights***

On June 8, 2000, the Company's Board of Directors declared a dividend distribution of one preferred stock purchase right (a "Right") for each share of the Company's common stock outstanding on July 6, 2000 and each share of common stock issued thereafter. Each Right entitles the registered shareholders to purchase from the Company one one-thousandth of a share of preferred stock at an exercise price of \$67, subject to adjustment. The Rights are not currently exercisable, but would become exercisable if certain events occurred relating to a person or group acquiring or attempting to acquire 15 percent or more of the Company's outstanding shares of common stock. The Rights expire on July 6, 2010, unless redeemed or exchanged by the Company earlier.

***Employee Stock Purchase Plan***

On September 15, 2000, the Company's shareholders approved the PFSweb Employee Stock Purchase Plan (the "Stock Purchase Plan") that is qualified under Section 423 of the Internal Revenue Code of 1986, to provide employees of the Company an opportunity to acquire a proprietary interest in the Company. The Stock Purchase Plan provides for acquisition of the Company's common stock at a 15% discount to the market value. The Stock Purchase Plan permits each U.S. employee who has completed ninety days of service to elect to participate in the plan. Eligible employees may elect to contribute with after-tax dollars up to a maximum annual contribution of \$25,000. The Company has reserved 2,000,000 shares of its common stock under the Stock Purchase Plan. The Stock Purchase Plan became effective for eligible employees in September 2000. During the years ended December 31, 2004, 2003 and 2002, the Company issued 226,381, 618,446 and 254,574 shares under the Stock Purchase Plan, respectively. As of December 31, 2004, there were 627,190 shares available for further issuance under the Stock Purchase Plan, of which 248,921 were issued in January 2005.

***Private Placement Transaction***

On November 7, 2003, the Company entered into a Securities Purchase Agreement with certain institutional investors in a private placement transaction pursuant to which the Company issued and sold an aggregate of 1,581,944 shares of its common stock, par value \$.001 per share (the "Common Stock"), at \$2.16 per share, resulting in gross proceeds of \$3.4 million. After deducting expenses, the net proceeds were approximately \$3.2 million. In addition to the Common Stock, the investors received one-year warrants to purchase an aggregate 525,692 shares of Common Stock at an exercise price of \$3.25 per share and four-year warrants to purchase an aggregate of 395,486 shares of Common Stock at an exercise price of \$3.30 per share. In January 2005, 394,685 of the one-year warrants were exercised prior to their expiration, generating net proceeds to the Company of \$1.3 million.

**PFSWEB, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (continued)**

***Stock Options and Stock Option Plans***

***PFSweb Plan Options***

The Company has authorized 6,000,000 shares of common stock for issuance under two 1999 stock option plans and 35,000 shares for issuance under a stock option agreement (the “Stock Option Plans”). The Stock Option Plans provide for the granting of incentive awards in the form of stock options to directors, executive management, key employees, and outside consultants of the Company. The right to purchase shares under the employee stock option agreements typically vest over a three-year period. Stock options must be exercised within 10 years from the date of grant. Stock options are generally issued at fair market value. The Company recorded stock based compensation expense of \$14,000, \$6,000 and \$28,000 in the years ended December 31, 2004, 2003 and 2002, respectively, in connection with stock options to purchase an aggregate of 65,000 shares issued under the Stock Option Plans to non-employees.

As of December 31, 2004, there were 1,069,030 shares available for future options under the Stock Option Plans.

The following table summarizes stock option activity under the Stock Option Plans:

	<u>Shares</u>	<u>Price Per Share</u>	<u>Weighted Average Exercise Price</u>
Outstanding, December 31, 2001	3,596,369	\$ 0.60 — \$16.00	\$ 1.27
Granted	1,090,000	\$ 0.44 — \$ 0.84	\$ 0.81
Exercised	—	\$ —	\$ —
Canceled	<u>(1,080,700)</u>	\$ 0.80 — \$10.45	\$ 1.29
Outstanding, December 31, 2002	3,605,669	\$ 0.44 — \$16.00	\$ 1.12
Granted	835,000	\$ 0.39 — \$ 2.26	\$ 0.42
Exercised	(328,730)	\$ 0.39 — \$ 1.92	\$ 0.81
Canceled	<u>(256,208)</u>	\$ 0.39 — \$ 1.92	\$ 1.10
Outstanding, December 31, 2003	3,855,731	\$ 0.39 — \$16.00	\$ 1.00
Granted	808,000	\$ 1.48 — \$ 2.96	\$ 1.64
Exercised	(160,133)	\$ 0.39 — \$ 1.92	\$ 0.85
Canceled	<u>(61,491)</u>	\$ 0.39 — \$10.45	\$ 1.65
Outstanding, December 31, 2004	<u><u>4,442,107</u></u>	\$ 0.39 — \$16.00	\$ 1.11

Stock Option Plan options generally vest one-twelfth each quarter. As of December 31, 2004 and 2003, 3,395,120 and 2,892,126 options were exercisable, respectively. The weighted average fair value per share of options granted during the years ended December 31, 2004, 2003 and 2002 was \$1.40, \$0.35 and \$0.67, respectively.

The following table summarizes information concerning currently outstanding and exercisable PFSweb stock options issued under the Stock Option Plans to PFSweb officers, directors and employees as of December 31, 2004:

<u>Options Outstanding</u>				<u>Options Exercisable</u>	
<u>Range of Exercise Prices</u>	<u>Outstanding as of December 31, 2004</u>	<u>Weighted Average Remaining Contractual Life</u>	<u>Weighted Average Exercise Price</u>	<u>Exercisable as of December 31, 2004</u>	<u>Weighted Average Exercise Price</u>
\$0.39 — \$ 0.91	2,991,658	7.3	\$ 0.77	2,586,245	\$ 0.82
\$1.16 — \$ 1.92	1,394,699	7.6	\$ 1.73	759,792	\$ 1.82
\$2.26 — \$ 2.96	48,000	6.3	\$ 2.68	41,333	\$ 2.68
\$10.45 — \$16.00	7,750	4.6	\$ 11.17	7,750	\$ 11.17
	<u><u>4,442,107</u></u>	7.4	\$ 1.11	<u><u>3,395,120</u></u>	\$ 1.09

***PFSweb Non-plan Options***

Prior to the Company’s initial public offering, certain of the Company’s employees were holders of stock options of the Company’s former parent company, Daisytek International Corporation (“Daisytek”), issued under Daisytek’s stock option plans.

**PFSWEB, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (continued)**

In connection with the completion of the Company's spin-off from Daisytek on July 6, 2000 (the "Spin-off"), all outstanding Daisytek stock options were replaced with substitute stock options. Daisytek options held by PFSweb employees were replaced (at the option holder's election made prior to the Spin-off) with either options to acquire shares of PFSweb common stock or options to acquire shares of both Daisytek common stock and PFSweb common stock (which may be exercised separately) (the "Unstapled Options"). Options held by Daisytek employees were replaced (at the option holder's election made prior to the Spin-off) with either options to acquire shares of Daisytek common stock or Unstapled Options.

As a result of the stock option replacement process described above, in conjunction with the Spin-off, PFSweb stock options (the "Non-plan Options") were issued to PFSweb and Daisytek officers, directors and employees. These options were issued as one-time grants and were not issued under the Stock Option Plans.

As of December 31, 2004, 473,269 Non-plan Options were outstanding, all of which were held by PFSweb officers, directors and employees.

The following table summarizes stock option activity under the Non-plan Options:

	<u>Shares</u>	<u>Price Per Share</u>	<u>Weighted Average Exercise Price</u>
Outstanding, December 31, 2001	1,431,503	\$0.91—\$10.58	\$ 1.15
Granted	—	\$ —	\$ —
Exercised	—	\$ —	\$ —
Canceled	(246,696)	\$0.91—\$10.58	\$ 1.59
Outstanding, December 31, 2002	1,184,807	\$0.91—\$10.58	\$ 1.05
Granted	—	\$ —	\$ —
Exercised	(320,838)	\$0.91—\$ 1.17	\$ 1.10
Canceled	(359,001)	\$0.91—\$ 1.17	\$ 1.16
Outstanding, December 31, 2003	504,968	\$0.91—\$10.58	\$ 0.95
Granted	—	\$ —	\$ —
Exercised	(31,130)	\$0.91—\$ 0.91	\$ 0.91
Canceled	(569)	\$5.78—\$10.58	\$ 6.47
Outstanding, December 31, 2004	<u>473,269</u>	\$0.91—\$10.58	\$ 0.95

As of December 31, 2004 and 2003, 473,269 and 504,968 of Non-plan Options outstanding were exercisable, respectively.

The following table summarizes information concerning Non-plan Options outstanding and exercisable as of December 31, 2004:

<u>Options Outstanding</u>				<u>Options Exercisable</u>	
<u>Range of Exercise Prices</u>	<u>Outstanding as of December 31, 2004</u>	<u>Weighted Average Remaining Contractual Life</u>	<u>Weighted Average Exercise Price</u>	<u>Exercisable as of December 31, 2004</u>	<u>Weighted Average Exercise Price</u>
\$ 0.91	471,039	6.9	\$ 0.91	471,039	\$ 0.91
\$ 5.78-\$10.58	2,230	3.0	\$ 8.83	2,230	\$ 8.83
	<u>473,269</u>	6.9	\$ 0.95	<u>473,269</u>	\$ 0.95

*Fair Value*

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions used for grants of PFSweb options to PFSweb officers, directors, and employees under the Stock Option Plans:

	<u>Year Ended December 31, 2004</u>	<u>Year Ended December 31, 2003</u>	<u>Year Ended December 31, 2002</u>
Expected dividend yield	—	—	—
Expected stock price volatility	107% - 118%	115% - 118%	112% - 114%
Risk-free interest rate	3.9% - 4.8%	3.4% - 4.3%	5.1%
Expected life of options (years)	5	5	5



**PFSWEB, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (continued)**

The fair value of each share of common stock granted under the Stock Purchase Plan is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	<u>Year Ended December 31, 2004</u>	<u>Year Ended December 31, 2003</u>	<u>Year Ended December 31, 2002</u>
Expected dividend yield	—	—	—
Expected stock price volatility	107% - 115%	115% - 119%	111% - 118%
Risk-free interest rate	0.9% - 2.2%	0.9% - 1.2%	1.2% - 1.8%
Expected life of options (months)	3	3	3

The weighted average fair value per share of common stock granted under the Stock Purchase Plan granted during the years ended December 31, 2004, 2003 and 2002 was \$0.74, \$0.51 and \$0.28, respectively.

**6. Master Distributor Agreements:**

Supplies Distributors, PFSweb and IBM have entered into master distributor agreements whereby Supplies Distributors acts as a master distributor of various IBM products and PFSweb provides transaction management and fulfillment services to Supplies Distributors. The master distributor agreements expire in March 2006 and can be extended for additional one-year terms upon mutual agreement by all parties. Under the master distributor agreements, IBM sells product to Supplies Distributors and reimburses Supplies Distributors for certain freight costs, direct costs incurred in passing on any price decreases offered by IBM to Supplies Distributors or its customers to cover price protection and certain special bids, the cost of products provided to replace defective product returned by customers and other certain expenses as defined. Supplies Distributors can return to IBM product rendered obsolete by IBM engineering changes after customer demand ends. IBM determines when a product is obsolete. IBM and Supplies Distributors also have verbal agreements under which IBM reimburses or collects from Supplies Distributors amounts calculated in certain inventory cost adjustments.

Supplies Distributors passes through to customers marketing programs specified by IBM and administer, along with GMS, such programs according to IBM guidelines.

**7. Impairment of Assets and Leases**

In September 2002, the Company changed the manner in which certain warehouse and order management transactions are processed. These changes eliminated the future service potential of selected software applications to the Company. Accordingly, the Company recorded a \$0.7 million asset impairment charge during the year ended December 31, 2002. The Company also abandoned certain distribution center assets and recorded a \$0.2 million asset impairment charge during the year ended December 31, 2002. In December 2003, the Company relocated its Canadian operations within Toronto. In conjunction with this relocation, the Company entered into a sublease agreement on the former facility as sub-lessor, and a sublease agreement on the new facility as sub-lessee. As such, the Company recorded an impairment expense for the operating lease on the former facility and the write-down of certain assets of approximately \$0.3 million during the year ended December 31, 2003.

**8. Restructuring**

In September 2002, the Company implemented a restructuring plan that resulted in the termination of approximately 60 employees, of which 20 were hourly employees. The Company recorded \$1.2 million for severance and other termination costs, of which \$0.3 million and \$0.8 million was paid during the years ended December 31, 2003 and 2002, respectively. The remaining \$0.1 million was paid during 2004.

**9. Supplies Distributors**

In September 2001, PFSweb made an equity investment of \$0.75 million in Supplies Distributors, for a 49% voting interest, and a third party made an equity investment of \$0.25 million in Supplies Distributors for a 51% voting interest. Certain officers and directors of PFSweb owned, individually, a 9.8% non-voting interest, and, collectively, a 49% non-voting interest, in the third party. Effective October 1, 2002, PFSweb purchased the remaining 51% interest in Supplies Distributors from the third party for \$0.3 million. As the acquired proportionate

**PFSWEB, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (continued)**

share of the fair value of Supplies Distributors' net assets was greater than the purchase price, the Company recognized an extraordinary gain on the purchase of \$0.2 million in accordance with SFAS No. 141.

Pursuant to the terms of PFSweb's transaction management services agreements with Supplies Distributors, PFSweb earned service fees, which, prior to the consolidation effective October 1, 2002 are reported as service fee revenue, affiliate in the accompanying consolidated financial statements, of approximately \$4.9 million.

Pursuant to an operating agreement, prior to the October 1, 2002 acquisition date, Supplies Distributors allocated its earnings and distributed its cash flow, as defined, in the following order of priority: first, to the third party until it received a one-time amount equal to its capital contribution of \$0.25 million; second, to the third party until it received an amount equal to a 35% cumulative annual return on its capital contribution; third, to PFSweb until it received a one-time amount equal to its capital contribution of \$0.75 million; fourth, to PFSweb until it received an amount equal to a 35% cumulative annual return on its capital contribution; and fifth, to PFSweb and the third party, pro rata, in accordance with their respective capital accounts. Effective October 1, 2002, as a result of PFSweb's 100% ownership of Supplies Distributors, future earnings will be allocated and dividends will be paid 100% to PFSweb. In addition, no distribution can be made if, after giving effect thereto, the net worth of Supplies Distributors would be less than \$1.0 million. At December 31, 2004, Supplies Distributors' net worth was \$7.6 million. Under the terms of its amended credit agreements, Supplies Distributors is currently restricted from paying annual cash dividends without the prior approval of its lenders (see Notes 3 and 4). In December 2002, Supplies Distributors paid a \$0.4 million dividend to PFSweb. In September 2003, Supplies Distributors paid a \$0.6 million dividend to PFSweb. In September and December 2004, Supplies Distributors paid a \$0.6 and \$0.2 million, respectively, dividend to PFSweb. PFSweb recorded \$1.2 million of equity in the earnings of Supplies Distributors, prior to the October 1, 2002 acquisition, for the year ended December 31, 2002.

The following summarizes the purchase price allocation of PFSweb's purchase of the remaining 51% interest in Supplies Distributors (in thousands):

Cash and cash equivalents (including restricted cash of \$1,745)	\$ 2,578
Accounts receivable	28,110
Inventories	37,193
Prepaid expenses	684
Other assets, net	284
Total assets acquired	<u>\$ 68,849</u>
Trade accounts payable	\$ 3,611
Accrued expenses	1,901
Debt (guaranteed by PFSweb)	48,823
Other debt	3,070
Note payable to affiliate	8,800
Total liabilities assumed	<u>66,205</u>
Net assets	2,644
Less PFSweb's prior investment	<u>2,109</u>
Net assets acquired	535
Less cash purchase price	<u>332</u>
Extraordinary gain on purchase.	<u>\$ 203</u>



**PFSWEB, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (continued)**

As a result of PFSweb's purchase of the remaining 51% interest in Supplies Distributors, effective October 1, 2002, PFSweb began consolidating 100% of Supplies Distributors' financial position and results of operations into the Company's consolidated financial statements. Following is an unaudited, pro forma, condensed consolidating income statement for calendar year 2002, as if the acquisition had occurred as of January 1, 2002, (in thousands):

	Calendar Year 2002			
	<u>PFSweb</u>	<u>Supplies Distributors</u>	<u>Pro Forma Adjustments</u>	<u>Pro Forma Consolidated</u>
Revenues:				
Gross product revenue	\$ —	\$ 221,145	\$ —	\$ 221,145
Service fee revenue	31,092	—	—	31,092
Service fee revenue, affiliate	6,525	—	(6,525)	—
Pass-through revenue	3,714	—	(151)	3,563
Net revenues	<u>41,331</u>	<u>221,145</u>	<u>(6,676)</u>	<u>255,800</u>
Costs of Revenues:				
Cost of product revenue	—	208,617	—	208,617
Cost of service fee revenue	23,252	—	(2,258)	20,994
Cost of pass-through revenue	3,714	—	(151)	3,563
Total costs of revenues	<u>26,966</u>	<u>208,617</u>	<u>(2,409)</u>	<u>233,174</u>
Gross profit	<u>14,365</u>	<u>12,528</u>	<u>(4,267)</u>	<u>22,626</u>
Selling, general and administrative expenses	26,206	6,997	(4,319)	28,884
Other	2,135	—	—	2,135
Income (loss) from operations	<u>(13,976)</u>	<u>5,531</u>	<u>52</u>	<u>(8,393)</u>
Equity in earnings of affiliate	1,429	—	(1,429)	—
Interest expense (income), net	<u>(847)</u>	<u>3,110</u>	<u>—</u>	<u>2,263</u>
Income (loss) before income taxes and extraordinary item	<u>(11,700)</u>	<u>2,421</u>	<u>(1,377)</u>	<u>(10,656)</u>
Income tax expense (benefit)	<u>(81)</u>	<u>929</u>	<u>(343)</u>	<u>505</u>
Income (loss) before extraordinary item	<u>(11,619)</u>	<u>1,492</u>	<u>(1,034)</u>	<u>(11,161)</u>
Extraordinary gain on purchase of 51% share of Supplies Distributors	203	—	—	203
Net income (loss)	<u><u>\$(11,416)</u></u>	<u><u>\$ 1,492</u></u>	<u><u>\$ (1,034)</u></u>	<u><u>\$ (10,958)</u></u>
Net loss per share:				
Basic and diluted	<u><u>\$ (0.63)</u></u>			<u><u>\$ (0.60)</u></u>
Weighted average number of shares outstanding, basic and diluted	<u><u>18,229</u></u>			<u><u>18,229</u></u>

The unaudited pro forma data are not necessarily indicative of the consolidated results of operations for future periods or the results of operations that would have been realized had the Company consolidated Supplies Distributors during the period presented.

As of December 31, 2004 and 2003, the Subordinated Note had an outstanding balance of \$7.0 million and \$8.0 million, respectively.

Under certain new and amended terms of certain of its debt facilities, the Subordinated Note cannot be increased to more than \$8.0 million or decreased to less than \$7.0 million without the prior approval of the Company's lenders (see Notes 3 and 4). The Subordinated Note accrues interest at a fluctuating rate per annum equal to PFSweb's cost of funds as determined by PFSweb, approximately 10% as of December 31, 2004 and 2003. During the year ended December 31, 2002, excluding the period from October 1, 2002 through December 31, 2002, PFSweb earned \$0.8 million of interest associated with the Subordinated Note.

**PFSWEB, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (continued)**

**10. Income Taxes**

A reconciliation of the difference between the expected income tax expense at the U.S. federal statutory corporate tax rate of 34%, and the Company's effective tax rate is as follows (in thousands):

	<b>Year Ended December 31, 2004</b>	<b>Year Ended December 31, 2003</b>	<b>Year Ended December 31, 2002</b>
Income tax provision (benefit) computed at statutory rate	\$ 326	\$ (1,079)	\$ (3,844)
Impact of foreign taxation	(9)	(48)	(230)
Items not deductible for tax (book) purposes	60	623	30
Change in valuation reserve	478	1,197	4,224
Other	(121)	(121)	(86)
Provision for income taxes	<u>\$ 734</u>	<u>\$ 572</u>	<u>\$ 94</u>

The consolidated income (loss) before income taxes, by domestic and foreign entities, is as follows (in thousands):

	<b>Year Ended December 31, 2004</b>	<b>Year Ended December 31, 2003</b>	<b>Year Ended December 31, 2002</b>
Domestic.	\$ (549)	\$ (2,745)	\$ (7,983)
Foreign	1,509	(429)	(3,526)
Total	<u>\$ 960</u>	<u>\$ (3,174)</u>	<u>\$ (11,509)</u>

Current and deferred income tax expense (benefit) is summarized as follows (in thousands):

	<b>Year Ended December 31, 2004</b>	<b>Year Ended December 31, 2003</b>	<b>Year Ended December 31, 2002</b>
Current			
Domestic	\$ 74	\$ 79	\$ —
State	49	64	—
Foreign	692	563	148
Total current	<u>815</u>	<u>706</u>	<u>148</u>
Deferred			
Domestic	—	—	(17)
State	—	(31)	—
Foreign	(81)	(103)	(37)
Total deferred	<u>(81)</u>	<u>(134)</u>	<u>(54)</u>
Total	<u>\$ 734</u>	<u>\$ 572</u>	<u>\$ 94</u>

The components of the deferred tax asset (liability) are as follows (in thousands):

	<b>December 31, 2004</b>	<b>December 31, 2003</b>
Deferred tax asset:		
Allowance for doubtful accounts	\$ 171	\$ 120
Inventory reserve	761	743
Property and equipment	74	—
Net operating loss carryforwards	10,812	10,063
Other	612	653
	<u>12,430</u>	<u>11,579</u>
Less — Valuation reserve	12,225	11,404
Total deferred tax asset	<u>205</u>	<u>175</u>
Deferred tax liability:		
Property and equipment	—	(155)
Other	(166)	(92)
Total deferred liability	<u>(166)</u>	<u>(247)</u>
Deferred tax asset (liability), net	<u>\$ 39</u>	<u>\$ (72)</u>



**PFSWEB, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (continued)**

Management believes that PFSweb has not established a sufficient history of earnings, on a stand-alone basis, to support the more likely than not realization of certain deferred tax assets in excess of existing taxable temporary differences. A valuation allowance has been provided for these net deferred income tax assets as of December 31, 2004 and 2003. At December 31, 2004, net operating loss carryforwards relate to taxable losses of PFSweb's Europe subsidiary totaling approximately \$11.9 million, PFSweb's Canada subsidiary totaling approximately \$2.7 million and PFSweb's U.S. subsidiary totaling approximately \$17.0 million that expire at various dates through 2019. The U.S. net operating loss carryforward includes \$4.6 million relating to tax benefits of stock option exercises and, if utilized, will be recorded against additional paid-in-capital upon utilization rather than as an adjustment to income tax expense from continuing operations.

**11. Commitments and Contingencies**

The Company leases facilities, warehouse, office, transportation and other equipment under operating leases expiring in various years through the year ended December 31, 2012. In most cases, management expects that, in the normal course of business, leases will be renewed or replaced by other leases. The Company also subleases a certain Canadian facility under a sublease agreement through the year ended December 31, 2006. Minimum future annual rental payments and sublease receipts under non-cancelable operating leases having original terms in excess of one year are as follows (in thousands):

	<b>Operating Lease Payments</b>	<b>Sub-Lease Income</b>
Fiscal year ended December 31,		
2005	\$ 6,207	\$ 161
2006	6,006	134
2007	4,638	—
2008	2,371	—
2009	393	—
Thereafter	1,049	—
Total	<u>\$ 20,664</u>	<u>\$ 295</u>

Total rental expense under operating leases approximated \$5.4 million, \$6.1 million and \$5.8 million for the years ended December 31, 2004, 2003 and 2002, respectively.

The Company receives municipal tax abatements in certain locations. During 2004 the Company received notice from a municipality that it did not satisfy certain criteria necessary to maintain the abatements. The Company plans to dispute the notice. If the dispute is not resolved favorably, the Company could be assessed additional taxes for calendar year 2004. The Company has not accrued for the additional taxes, which for 2004 could be \$0.4 million to \$0.5 million, as it does not believe that it is probable that an additional assessment will be incurred.

**12. Segment and Geographic Information**

The Company is organized into two operating segments: PFSweb, is an international provider of integrated business process outsourcing solutions and operates as a service fee business; Supplies Distributors is a master distributor of primarily IBM products.

	<b>Year Ended December 31, 2004</b>	<b>Year Ended December 31, 2003</b>	<b>Year Ended December 31, 2002</b>
Revenues (in thousands):			
PFSweb	\$ 62,621	\$ 44,824	\$ 41,331
Supplies Distributors	267,470	249,230	57,492
Eliminations	(8,426)	(7,618)	(1,814)
	<u>\$ 321,665</u>	<u>\$ 286,436</u>	<u>\$ 97,009</u>
Income (loss) from operations (in thousands):			
PFSweb	\$ (3,495)	\$ (6,317)	\$ (13,976)
Supplies Distributors	5,908	5,114	1,127
Eliminations	7	29	16
	<u>\$ 2,420</u>	<u>\$ (1,174)</u>	<u>\$ (12,833)</u>

**PFSWEB, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (continued)**

	<u>Year Ended December 31, 2004</u>	<u>Year Ended December 31, 2003</u>	<u>Year Ended December 31, 2002</u>
Depreciation and amortization (in thousands):			
PFSweb	\$ 4,636	\$ 4,469	\$ 5,836
Supplies Distributors	14	58	31
Eliminations	(7)	(30)	(16)
	<u>\$ 4,643</u>	<u>\$ 4,497</u>	<u>\$ 5,851</u>
Capital expenditures (in thousands):			
PFSweb	\$ 7,698	\$ 1,982	\$ 1,762
Supplies Distributors	—	—	—
Eliminations	—	—	—
	<u>\$ 7,698</u>	<u>\$ 1,982</u>	<u>\$ 1,762</u>
		<u>December 31, 2004</u>	<u>December 31, 2003</u>
Assets (in thousands):			
PFSweb		\$ 56,610	\$ 43,629
Supplies Distributors		88,548	77,878
Eliminations		(14,831)	(13,148)
		<u>\$ 130,327</u>	<u>\$ 108,359</u>

Geographic areas in which the Company operates include the United States, Europe (primarily Belgium), and Canada. The following is geographic information by area. Revenues are attributed based on the Company's domicile.

	<u>Year Ended December 31, 2004</u>	<u>Year Ended December 31, 2003</u>	<u>Year Ended December 31, 2002</u>
Revenues (in thousands):			
United States	\$ 225,300	\$ 199,309	\$ 73,752
Europe	99,979	89,781	21,358
Canada	9,834	12,730	5,335
Inter-segment eliminations	(13,448)	(15,384)	(3,436)
	<u>\$ 321,665</u>	<u>\$ 286,436</u>	<u>\$ 97,009</u>
		<u>December 31, 2004</u>	<u>December 31, 2003</u>
Long-lived assets (in thousands):			
United States		\$ 12,288	\$ 6,419
Europe		3,641	4,166
Canada		138	185
		<u>\$ 16,067</u>	<u>\$ 10,770</u>

### 13. Employee Savings Plan

The Company has a defined contribution employee savings plan under Section 401(k) of the Internal Revenue Code. Substantially all full-time and part-time U.S. employees are eligible to participate in the plan. The Company, at its discretion, may match employee contributions to the plan and also make an additional matching contribution in the form of profit sharing in recognition of the Company's performance. During the year ended December 31, 2004, the Company matched 20% of employee contributions totaling approximately \$60,000. During the years ended December 31, 2003 and 2002, the Company matched 10% of employee contributions totaling approximately \$30,000 and \$34,000, respectively.

### 14. Quarterly Results of Operations (Unaudited)

Unaudited quarterly results of operations for years ended December 31, 2004 and 2003 were as follows (amounts in thousands except per share data):



**PFSWEB, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (continued)**

	<b>Year Ended December 31, 2004</b>			
	<b><u>1<sup>st</sup> Qtr.</u></b>	<b><u>2<sup>nd</sup> Qtr.</u></b>	<b><u>3<sup>rd</sup> Qtr.</u></b>	<b><u>4<sup>th</sup> Qtr.</u></b>
Total revenues	\$ 77,485	\$ 80,020	\$ 77,017	\$ 87,143
Total cost of revenues	71,490	72,119	69,630	78,915
Gross profit	5,995	7,901	7,387	8,228
Selling, general and administrative expenses	7,132	6,910	6,451	6,598
Income (loss) from operations	(1,137)	991	936	1,630
Net income (loss)	(1,767)	479	420	1,094
Basic net income (loss) per share	(0.08)	0.02	0.02	0.05
Diluted net income (loss) per share	(0.08)	0.02	0.02	0.05

  

	<b>Year Ended December 31, 2003</b>			
	<b><u>1<sup>st</sup> Qtr.</u></b>	<b><u>2<sup>nd</sup> Qtr.</u></b>	<b><u>3<sup>rd</sup> Qtr.</u></b>	<b><u>4<sup>th</sup> Qtr.</u></b>
Total revenues	\$ 67,091	\$ 74,573	\$ 69,400	\$ 75,372
Total cost of revenues	62,019	66,881	63,658	69,353
Gross profit	5,072	7,692	5,742	6,019
Selling, general and administrative expenses	6,177	6,516	6,336	6,413
Asset and lease impairments	—	—	—	257
Income (loss) from operations	(1,105)	1,176	(594)	(651)
Net income (loss)	(1,774)	467	(1,141)	(1,298)
Basic and diluted net income (loss) per share	(0.10)	0.03	(0.06)	(0.06)

The seasonality of the Company's business is dependent upon the seasonality of its clients' business and their sale of products. Management believes that with the Company's current client mix and their clients' business volumes, the Company's service fee revenue business activity is expected to be at its lowest in the quarter ended March 31. Due to anticipated product release schedule changes from certain clients, the Company does not believe this seasonal impact will be as significant in 2005 as it has been in prior years. The Company's product revenue business activity is expected to be at its highest in the quarter ended December 31.



**Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure**

None.

**Item 9A. Controls and Procedures**

The term “disclosure controls and procedures” is defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, or the Exchange Act. This term refers to the controls and procedures of a company that are designed to provide reasonable assurance that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the Securities and Exchange Commission. Our management, including our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this annual report. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were effective in all material respects as of the end of the period covered by this annual report.

There were no changes to our internal control over financial reporting during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART III**

**Item 10. Directors and Executive Officers of the Registrant**

Reference is made to the information to be set forth in the section entitled “Board of Directors” and “Committees of the Board” in the definitive proxy statement in connection with our Annual Meeting of Stockholders (the “Proxy Statement”), which section is incorporated herein by reference. Our Proxy Statement will be filed with the Securities and Exchange Commission not later than 120 days after the last day of our fiscal year ended December 31, 2004.

**Item 11. Executive Compensation**

Information required by Part III, Item 11, will be included in the section entitled “Election of Directors” of our Proxy Statement relating to our annual meeting of stockholders and is incorporated herein by reference.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

Information required by Part III, Item 12, will be included in the Sections entitled “Election of Directors” and “Security Ownership of Certain Beneficial Owners and Management” of our Proxy Statement relating to our annual meeting of stockholders and is incorporated herein by reference.

The following table summarizes information with respect to equity compensation plans under which equity securities of the registrant are authorized for issuance as of December 31, 2004:

<b>Plan category (1)</b>	<b>Number of securities to be issued upon exercise of outstanding options and warrants</b>	<b>Weighted-average exercise price of outstanding options and warrants</b>	<b>Number of securities remaining available for future issuance</b>
Equity compensation plans approved by security holders	4,442,107	\$ 1.11	1,069,030
Equity compensation plans not approved by security holders	473,269	\$ 0.95	—
Total	<u>4,915,376</u>		<u>1,069,030</u>

(1) See Note 5 to the Consolidated Financial Statements for more detailed information regarding the registrant’s equity compensation plans.

**Item 13. Certain Relationship and Related Transactions**

Information regarding certain of our relationships and related transactions will be included in the section entitled “Certain Relationship and Related Transactions” of our Proxy Statement relating to our annual meeting of stockholders and is incorporated herein by reference.

**Item 14. Principal Accountant and Fees and Services**

Information required by Part III, Item 14, will be included in the section entitled “Ratification of Appointment of Independent Auditors” of our Proxy Statement relating to our annual meeting of stockholders and is incorporated herein by reference.

**PART IV****Item 15. Exhibits and Financial Statement Schedules**

(a) *The following documents are filed as part of this report:*

**1. Financial Statements**

PFSweb, Inc. and Subsidiaries

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets

Consolidated Statements of Operations

Consolidated Statements of Shareholders’ Equity and Comprehensive Income (Loss)

Consolidated Statements of Cash Flows

Notes to Consolidated Financial Statements

*Financial Statement Schedules*

Schedule I – Condensed Financial Information of Registrant

Schedule II – Valuation and Qualifying Accounts

All other schedules are omitted because the required information is not present in amounts sufficient to require submission of the schedule or because the information required is included in the financial statements or notes thereto.

**2. Exhibits**

<b>Exhibit Number</b>	<b>Description of Exhibits</b>
2.1 (1)	Tax Indemnification and Allocation Agreement between Daisytek, International Corporation and PFSweb, Inc.
3.1 (1)	Amended and Restated Certificate of Incorporation
3.2 (1)	Amended and Restated Bylaws
10.1 (1)	Non-Employee Director Stock Option and Retainer Plan
10.2 (1)	Employee Stock Option Plan
10.3 (1)	Employee Annual Incentive Plan
10.4 (1)	Industrial Lease Agreement between Shelby Drive Corporation and Priority Fulfillment Services, Inc.
10.5 (1)	Lease Contract between Transports Weerts and Priority Fulfillment Services Europe B.V.
10.6 (2)	Form of Change of Control Agreement between the Company and each of its executive officers
10.7 (4)	Ninth Amendment to Lease Agreement by and between AGBRI ATRIUM. L.P., and Priority Fulfillment Services, Inc.
10.8 (5)	Agreement for Inventory Financing by and among Business Supplies



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Exhibit Number	Description of Exhibits
	Distributors Holdings, LLC, Supplies Distributors, Inc., Priority Fulfillment Services, Inc., PFSweb, Inc., Inventory Financing Partners, LLC and IBM Credit Corporation
10.9 (5)	Amended and Restated Collateralized Guaranty by and between Priority Fulfillment Services, Inc. and IBM Credit Corporation
10.10 (5)	Amended and Restated Guaranty to IBM Credit Corporation by PFSweb, Inc.
10.11 (5)	Amended and Restated Notes Payable Subordination Agreement by and between Priority Fulfillment Services, Inc., Supplies Distributors, Inc. and IBM Credit Corporation
10.12 (5)	Amended and Restated Platinum Plan Agreement (with Invoice Discounting) by and among Supplies Distributors, S.A., Business Supplies Distributors Europe B.V., PFSweb B.V., and IBM Belgium Financial Services S.A.
10.13 (5)	Amended and Restated Collateralized Guaranty between Priority Fulfillment Services, Inc. and IBM Belgium Financial Services S.A.
10.14 (5)	Amended and Restated Guaranty to IBM Belgium Financial Services S.A. by PFSweb, Inc.
10.15 (5)	Subordinated Demand Note by and between Supplies Distributors, Inc. and Priority Fulfillment Services, Inc.
10.16 (5)	Notes Payable Subordination Agreement between Congress Financial Corporation (Southwest) and Priority Fulfillment Services, Inc.
10.17 (5)	Guarantee in favor of Congress Financial Corporation (Southwest) by Business Supplies Distributors Holdings, LLC, Priority Fulfillment Services, Inc. and PFSweb, Inc.
10.18 (5)	General Security Agreement by Priority Fulfillment Services, Inc. in favor of Congress Financial Corporation (Southwest).
10.19 (5)	Inducement Letter by Priority Fulfillment Services, Inc. and PFSweb, Inc. in favor of Congress Financial Corporation (Southwest).
10.20 (6)	Form of Executive Severance Agreement between the Company and each of its executive officers.
10.21 (7)	Amendment to Agreement for Inventory Financing by and among Business Supplies Distributors Holdings, LLC, Supplies Distributors, Inc., Priority Fulfillment Services, Inc., PFSweb, Inc., Inventory Financing Partners, LLC and IBM Credit Corporation
10.22 (7)	Amendment to Amended and Restated Platinum Plan Agreement (with Invoice Discounting) by and among Supplies Distributors, S.A., Business Supplies Distributors Europe B.V., PFSweb B.V., and IBM Belgium Financial Services S.A.
10.23 (7)	Amended and Restated Notes Payable Subordination Agreement by and between Priority Fulfillment Services, Inc., Supplies Distributors, Inc. and IBM Credit Corporation
10.24 (7)	Amendment to Factoring agreement dated March 29, 2002 between Supplies Distributors S.A. and Fortis Commercial Finance N.V.
10.25 (8)	Loan and Security Agreement by and between Comerica Bank – California (“Bank”) and Priority Fulfillment Services, Inc. (“Priority”) and Priority Fulfillment Services of Canada, Inc. (“Priority Canada”)
10.26 (8)	Unconditional Guaranty of PFSweb, Inc. to Comerica Bank – California
10.27 (8)	Security Agreement of PFSweb, Inc. to Comerica Bank – California
10.28 (8)	Intellectual Property Security Agreement between Priority Fulfillment Services, Inc. and Comerica Bank – California
10.29 (8)	Amendment 2 to Amended and Restated Platinum Plan Agreement (with Invoice Discounting) by and among Supplies Distributors, S.A., Business Supplies Distributors B.V., PFSweb B.V., and IBM Belgium Financial Services S.A.
10.30 (8)	Amendment to Agreement for Inventory Financing by and among Business Supplies Distributors Holdings, LLC, Supplies Distributors, Inc.,



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Exhibit Number	Description of Exhibits
	Priority Fulfillment Services, Inc., PFSweb, Inc., and IBM Credit LLC
10.31 (9)	Amendment to factoring agreement dated April 30, 2003 between Supplies Distributors S.A. and Fortis Commercial Finance N.V.
10.32 (9)	Loan and Security Agreement by and between Congress Financial Corporation (Southwest), as Lender and Supplies Distributors, Inc., as Borrower dated March 29, 2002.
10.33 (9)	General Security Agreement – Business Supplies Distributors Holdings, LLC in favor of Congress Financial Corporation (Southwest)
10.34 (9)	Stock Pledge Agreement between Supplies Distributors, Inc. and Congress Financial Corporation (Southwest)
10.35 (9)	First Amendment to General Security Agreement by Priority Fulfillment Services, Inc. in favor of Congress Financial Corporation (Southwest)
10.36 (10)	First Amendment to Loan and Security Agreement made as of September 11, 2003 by and between Priority Fulfillment Services, Inc., Priority Fulfillment Services of Canada, Inc. and Comerica Bank.
10.37 (11)	Securities Purchase Agreement dated as of November 7, 2003 between PFSweb, Inc. and the Purchasers named therein.
10.38 (11)	Form of One Year Warrant dated as of November 7, 2003 issued to each of the Purchasers pursuant to the Securities Purchase Agreement.
10.39 (11)	Form of Four Year Warrant dated as of November 7, 2003 issued to each of the Purchasers pursuant to the Securities Purchase Agreement.
10.40 (12)	Industrial Lease Agreement between New York Life Insurance Company and DaisYTEK, Inc.
10.41 (12)	First Amendment to Industrial Lease Agreement between New York Life Insurance Company, DaisYTEK, Inc. and Priority Fulfillment Services, Inc.
10.42 (12)	Second Amendment to Industrial Lease Agreement between ProLogis North Carolina Limited Partnership and Priority Fulfillment Services, Inc.
10.43 (12)	Modification, Ratification and Extension of Lease between Shelby Drive Corporation and Priority Fulfillment Services, Inc.
10.44 (13)	Amendment to Agreement for Inventory Financing by and among Business Supplies Distributors Holdings, LLC, Supplies Distributors, Inc., Priority Fulfillment Services, Inc., PFSweb, Inc., and IBM Credit LLC
10.45 (13)	Amendment 4 to Amended and Restated Platinum Plan Agreement (with Invoice Discounting) by and among Supplies Distributors, S.A., Business Supplies Distributors B.V., PFSweb B.V., and IBM Belgium Financial Services S.A.
10.46 (13)	Third Amended and Restated Notes Payable Subordination Agreement by and between Priority Fulfillment Services, Inc., Supplies Distributors, Inc. and IBM Credit Corporation
10.47 (13)	First Amendment to Loan and Security Agreement by and between Congress Financial Corporation (Southwest), as Lender and Supplies Distributors, Inc., as Borrower.
10.48 (13)	Form of Modification to Executive Severance Agreement.
10.49 (14)	Industrial Lease Agreement by and between Industrial Developments International, Inc. and Priority Fulfillment Services, Inc.
10.50 (14)	Guaranty by PFSweb, Inc. in favor of Industrial Developments International, Inc.
10.51 (14)	Lease between Fleet National Bank and Priority Fulfillment Services, Inc.
10.52 (14)	Guaranty by PFSweb, Inc. in favor of Fleet National Bank
10.53 (14)	Amendment No. 3 to Lease dated as of March 3, 1999 between Fleet National Bank and Priority Fulfillment Services, Inc.
10.54 (15)	Loan Agreement between Mississippi Business Finance Corporation and Priority Fulfillment Services, Inc. dated as of November 1, 2004

- 10.55 (15) Placement Agreement between Priority Fulfillment Services, Inc., Comerica Securities and Mississippi Business Finance Corporation
- 10.56 (15) Reimbursement Agreement between Priority Fulfillment Services, Inc. and Comerica Bank



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<b>Exhibit Number</b>	<b>Description of Exhibits</b>
10.57 (15)	First Amended and Restated Loan and Security Agreement by and between Comerica Bank and Priority Fulfillment Services, Inc.
10.58 (15)	Remarketing Agreement between Priority Fulfillment Services, Inc. and Comerica Securities
23.1 (15)	Consent of KPMG LLP
31.1 (15)	Certifications of Principal Executive Officer Pursuant to 18 U.S.C. Section 1350
31.2 (15)	Certifications of Principal Financial Officer Pursuant to 18 U.S.C. Section 1350
32.1 (16)	Certifications of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

- 
- (1) Incorporated by reference from PFSweb, Inc. Registration Statement on Form S-1 (Commission File No. 333-87657).
  - (2) Incorporated by reference from PFSweb, Inc. Form 10-K for the fiscal year ended March 31, 2001
  - (3) Incorporated by reference from PFSweb, Inc. Form 10-Q/A for the quarterly period ended September 30, 2001
  - (4) Incorporated by reference from PFSweb, Inc. Form 10-K for the transition period ended December 31, 2001
  - (5) Incorporated by reference from PFSweb, Inc. Form 10-Q for the quarterly period ended March 31, 2002
  - (6) Incorporated by reference from PFSweb, Inc. Form 10-Q for the quarterly period ended June 30, 2002
  - (7) Incorporated by reference from PFSweb, Inc. Form 10-K for the year ended December 31, 2002
  - (8) Incorporated by reference from PFSweb, Inc. Form 10-Q for the quarterly period ended March 31, 2003
  - (9) Incorporated by reference from PFSweb, Inc. Form 10-Q for the quarterly period ended June 30, 2003
  - (10) Incorporated by reference from PFSweb, Inc. Form 10-Q for the quarterly period ended September 30, 2003
  - (11) Incorporated by reference from PFSweb, Inc. Report on Form 8-K filed on November 10, 2003
  - (12) Incorporated by reference from PFSweb, Inc. Form 10-K for the year ended December 31, 2003
  - (13) Incorporated by reference from PFSweb, Inc. Form 10-Q for the quarterly period ended March 31, 2004
  - (14) Incorporated by reference from PFSweb, Inc. Form 10-Q for the quarterly period ended September 30, 2004
  - (15) Filed herewith
  - (16) Furnished herewith

## PFSWEB, INC. AND SUBSIDIARIES

**CONDENSED FINANCIAL INFORMATION OF REGISTRANT**  
**BALANCE SHEETS – PARENT COMPANY ONLY**  
(In thousands)

	<u>December 31,</u> <u>2004</u>	<u>December 31,</u> <u>2003</u>
<b>ASSETS:</b>		
Cash and cash equivalents	\$ —	\$ —
Receivable from Priority Fulfillment Services, Inc.	4,771	4,296
Investment in subsidiaries	<u>25,155</u>	<u>24,121</u>
Total assets	<u>\$ 29,926</u>	<u>\$ 28,417</u>
<b>LIABILITIES:</b>		
Total liabilities	\$ —	\$ —
<b>SHAREHOLDERS' EQUITY:</b>		
Preferred stock	—	—
Common stock	22	21
Additional paid-in capital	56,645	56,156
Accumulated deficit	(29,077)	(29,303)
Accumulated other comprehensive income	2,421	1,628
Treasury stock	<u>(85)</u>	<u>(85)</u>
Total shareholders' equity	<u>29,926</u>	<u>28,417</u>
Total liabilities and shareholders' equity	<u>\$ 29,926</u>	<u>\$ 28,417</u>

The condensed financial statements should be read in conjunction with the consolidated financial statements and notes.

PFSWEB, INC. AND SUBSIDIARIES

CONDENSED FINANCIAL INFORMATION OF REGISTRANT  
STATEMENTS OF OPERATIONS – PARENT COMPANY ONLY  
FOR THE YEARS ENDED DECEMBER 31  
(In thousands)

	2004	2003	2002
EQUITY IN NET INCOME OF UNCONSOLIDATED SUBSIDIARY	\$ —	\$ —	\$ 1,163
EQUITY IN NET INCOME (LOSS) OF CONSOLIDATED SUBSIDIARIES	226	(3,746)	(12,563)
NET INCOME (LOSS)	<u>\$ 226</u>	<u>\$ (3,746)</u>	<u>\$ (11,400)</u>

The condensed financial statements should be read in conjunction with the consolidated financial statements and notes.

## PFSWEB, INC. AND SUBSIDIARIES

**CONDENSED FINANCIAL INFORMATION OF REGISTRANT  
STATEMENTS OF CASH FLOWS – PARENT COMPANY ONLY  
FOR THE YEARS ENDED DECEMBER 31  
(In thousands)**

	<u>2004</u>	<u>2003</u>	<u>2002</u>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income (loss)	\$ 226	\$ (3,746)	\$(11,400)
Adjustments to reconcile net loss to net cash provided by operating activities:			
Equity in net income of unconsolidated subsidiary	—	—	(1,163)
Equity in net (income) loss of consolidated subsidiaries	<u>(226)</u>	<u>3,746</u>	<u>12,563</u>
Net cash provided by operating activities	<u>—</u>	<u>—</u>	<u>—</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Net proceeds from issuance of common stock	475	4,059	124
Increase in receivable from Priority Fulfillment Services, Inc.	<u>(475)</u>	<u>(4,081)</u>	<u>(124)</u>
Net cash used in financing activities	<u>—</u>	<u>(22)</u>	<u>—</u>
<b>NET DECREASE IN CASH</b>	<u>—</u>	<u>(22)</u>	<u>—</u>
<b>CASH AND CASH EQUIVALENTS, beginning of period</b>	<u>—</u>	<u>22</u>	<u>22</u>
<b>CASH AND CASH EQUIVALENTS, end of period</b>	<u><u>\$ —</u></u>	<u><u>\$ —</u></u>	<u><u>\$ 22</u></u>

The condensed financial statements should be read in conjunction with the consolidated financial statements and notes.

## PFSWEB, INC. AND SUBSIDIARIES

VALUATION AND QUALIFYING ACCOUNTS  
FOR THE YEARS ENDED DECEMBER 31

(Amounts in thousands)

	<u>Balance at Beginning of Period</u>	<u>Additions</u>		<u>Deductions</u>	<u>Balance at End of Period</u>
		<u>Charges to Cost and Expenses</u>	<u>Charges to Other Accounts</u>		
Year Ended December 31, 2002:					
Allowance for doubtful accounts	\$ 254	38	152	(33)	\$ 411
Allowance for slow moving inventory	\$ —	10	132	—	\$ 142
Income tax valuation allowance	\$ 5,429	4,224	554	—	\$ 10,207
Year Ended December 31, 2003:					
Allowance for doubtful accounts	\$ 411	351	—	(423)	\$ 339
Allowance for slow moving inventory	\$ 142	1,984	—	(812)	\$ 1,314
Income tax valuation allowance	\$ 10,207	1,197	—	—	\$ 11,404
Year Ended December 31, 2004:					
Allowance for doubtful accounts	\$ 339	289	—	(124)	\$ 504
Allowance for slow moving inventory	\$ 1,314	1,204	—	(45)	\$ 2,473
Income tax valuation allowance	\$ 11,404	821	—	—	\$ 12,225

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

By: /s/ THOMAS J. MADDEN

Thomas J. Madden,  
*Executive Vice President and  
Chief Financial and Accounting Officer*

Pursuant to the requirements of the Securities Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ MARK C. LAYTON</u> Mark C. Layton	Chairman of the Board, President and Chief Executive Officer (Principal Executive Officer)	March 31, 2005
<u>/s/ THOMAS J. MADDEN</u> Thomas J. Madden	Executive Vice President and Chief Financial and Accounting Officer (Principal Financial and Accounting Officer)	March 31, 2005
<u>/s/ DR. NEIL JACOBS</u> Dr. Neil Jacobs	Director	March 31, 2005
<u>/s/ TIMOTHY M. MURRAY</u> Timothy M. Murray	Director	March 31, 2005
<u>/s/ JAMES F. REILLY</u> James F. Reilly	Director	March 31, 2005
<u>/s/ DAVID I. BEATSON</u> David I. Beatson	Director	March 31, 2005

**Exhibit 10.54**

**LOAN AGREEMENT**

**Between**

**MISSISSIPPI BUSINESS FINANCE CORPORATION**  
(the "Issuer")

and

**PRIORITY FULFILLMENT SERVICES, INC.**  
(the "Obligor")

Relating to the  
Issuance of

\$5,000,000

Mississippi Business Finance Corporation  
Taxable Variable Rate Demand

Limited Obligation Revenue Bonds, Series 2004

(Priority Fulfillment Services, Inc. Project)

**Dated as of November 1, 2004**

The interest (subject to certain specified exclusions) of the Issuer in this Loan Agreement has been assigned to U.S. Bank National Association, in its capacity as Trustee (the "Trustee") under a Trust Indenture dated as of November 1, 2004, between the Issuer and the Trustee.



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## **LOAN AGREEMENT**

THIS LOAN AGREEMENT (the "Agreement") is made and entered into as of November 1, 2004, by and between the Mississippi Business Finance Corporation (the "Issuer") and Priority Fulfillment Services, Inc., a Delaware corporation (the "Obligor").

### **DEFINITIONS**

Except as provided herein, all capitalized terms shall have the meanings ascribed to them in the Indenture (defined below). In addition to the words and terms elsewhere defined in the Agreement, each of the following words and terms as used in the Agreement shall have the following meaning unless the context or use indicates another or different meaning or intent and shall refer to all or part of the defined subject.

"Additional Bonds" means the Additional Bonds which are authorized to be issued in accordance with Section 112 of the Indenture in one or more series from time to time to provide funds for the purposes contemplated by the Agreement.

"Completion Certificate" means the certificate provided for in Section 4.3 hereof, in the form of Exhibit C hereto.

"Completion Date" means the date of completion of the Project as such date shall be certified in the Completion Certificate.

"Event of Default" means those events of default specified and defined in Section 10.1.

"General Limitations" means those general limitations on the Obligor action or failure to act specified in Section 9.3 hereof, sometimes referenced as a condition to a particular Obligor action, but applicable to any action by the Obligor under the Agreement.

"Improvements to the Project" means such additions, improvements, modifications or relocations as the Obligor may deem necessary or desirable in, on or to the Project, all of which shall become part of the Project.

"Indemnified Persons" means the Issuer and its members, officers, agents and employees.

"Indenture" means the Trust Indenture between the Issuer and the Trustee, dated as of November 1, 2004, as the same may be amended or supplemented in accordance with its terms.

"Inducement Date" means August 18, 2004, on which date a resolution of intent or inducement to assist in the financing of the Project was adopted by the Mississippi Business Finance Corporation.

"Issuance Costs" means items of expense payable or reimbursable directly or indirectly by the Issuer and related to the authorization, sale and issuance of the Bonds and authorization and execution of the Agreement, which items of expense shall include, but not be limited to, the Issuer's fee, application fees and expenses, publication costs, printing costs, costs of reproducing documents, filing and recording fees, Bond Counsel and Counsel fees, initial Trustee's fees,

initial Remarketing Agent's fees, placement agents' fees, costs of credit ratings, Credit Facility issuance fees and charges for execution, transportation and safekeeping of the Bonds and related documents, and other costs, charges and fees in connection with the foregoing.

"Issuance Fee" means the Bond issuance fee payable to the Issuer on or before the Effective Date in the amount of \$15,000.

"Municipality" means the City of Southaven, Mississippi.

"Permitted Encumbrances" means and includes (a) the rights of the Issuer, the Trustee and the Bank and the liens created under the Agreement; (b) the rights of the Issuer, the Trustee and the Bank created under the Indenture and assignment of the Agreement; (c) any lien, encumbrance or charge, which is subordinate in all respects to the interest of the Issuer, the Trustee and the Bank; (d) any liens granted to the Bank; and (e) liens permitted by the Reimbursement Agreement or consented to by the Bank in writing.

"Project" means the acquisition and installation of machinery, equipment and fixtures in a distribution facility located in the Municipality, as more fully described in Exhibit A hereto, including such modifications thereof, substitutions therefor, and Improvements to the Project, and excluding such deletions therefrom, as shall be made in accordance with the Agreement.

"Project Costs" means (a) obligations of the Issuer or the Obligor incurred for labor and materials and to contractors, builders and materialmen in connection with the acquisition, construction, equipping and installation of the Project; (b) the cost of contract bonds and of insurance of all kinds that may be required or necessary during the course of construction of the Project which is not paid by the contractor or contractors or otherwise provided for; (c) all costs of engineering services, including test borings, surveys, estimates, plans and specifications and preliminary investigations, and supervising construction, as well as for the performance of all other duties required by or consequent upon the proper construction of the Project; (d) Issuance Costs; (e) all other costs which the Obligor shall be required to pay, under the terms of any contract or contracts, for the acquisition, construction, equipping and installation of the Project; (f) other costs of a nature comparable to those described in clauses (a) through (e) above which the Obligor shall be required to pay as a result of the damage, destruction, condemnation or taking of the Project or any portion thereof; (g) interest on the Bonds or any interim obligation during the period of construction of the Project; or (h) any other costs incurred by the Obligor which are properly chargeable to the Project and which may be financed by the Bonds under the Act.

"Project Purposes" means use of the Project in connection with logistics and distribution.

The terms "redemption", "redeem" and "redeemed" when used with reference to the principal of the Bonds, means, when appropriate, prepayment, prepay and prepaid, respectively.

"Requisition Certificate" means the certificate required by Section 4.1 hereof, in the form of Exhibit B hereto.

## **PREMISES**

The Issuer is empowered under the Act to assist any person, firm or corporation in the financing of certain projects and facilities, through the issuance of its limited obligation revenue bonds. The Obligor has proposed the acquisition, equipping and installation of the Project and as an inducement therefor has requested the Issuer to assist in the financing of the Project and certain other expenses incidental thereto, as provided in the Act.

The Issuer has determined that making the Loan to the Obligor will promote and serve the intended purposes of, and in all respects will conform to the provisions and requirements of the Act. In order to grant the Loan and thereby assist in the financing of the Project, the Issuer is issuing the Bonds. The Issuer, the Trustee and the Obligor understand and intend that the financing of the Project through issuance of the Bonds and the making of the Loan will be structured in the following general manner, as detailed in the Indenture and in the Agreement: The Issuer will issue the Bonds under the Act and use the principal amount thereof to make the Loan to the Obligor. The Loan shall be repaid by the Obligor in Loan Repayments sufficient to pay the principal, premium, if any, and interest on the Bonds as the same become due. From the proceeds of the Loan, the Obligor will acquire, equip and install the Project. Under the terms of this Agreement, the Obligor will make Loan Repayments, and will be responsible for paying any costs of the Project which exceed the principal amount of the Bonds, for maintaining and insuring the Project, and for paying all taxes and expenses relating to the Project. The Issuer's obligation with respect to the Bonds is subject to the limitations herein contained, viz., that the principal, premium, if any, and interest on the Bonds and any other costs or pecuniary liability relating to the Bonds, the Loan, the acquisition, equipping and installation of the Project or any proceeding, document, or certification incidental to the foregoing, shall never be payable from tax revenues or public funds of the State or any agency thereof or general funds or assets of the Issuer, but shall be payable with Available Moneys solely and only from the Security. The Bonds shall not be secured by any interest in the Project or other assets of the Obligor.

In addition, as part of the Security for the Loan Repayments the Obligor will cause to be delivered to the Trustee the Credit Facility of the Bank. The Trustee is instructed in the Indenture to draw under the Credit Facility up to (a) the principal amount of the Bonds (i) to enable the Trustee to pay the principal amount of the Bonds when due at maturity, by acceleration of maturity or otherwise or upon redemption or (ii) to enable the Trustee to pay the portion of the Purchase Price of Bonds delivered to the Trustee and not remarketed by the Remarketing Agent equal to the principal amount of such Bonds, plus (b) an amount equal to 45 days' (or, if required pursuant to Section 208 of the Indenture, 210 days') interest on the Bonds calculated at the Maximum Rate to enable the Trustee to pay interest on the Bonds plus (c) if the Credit Facility is so amended, any premium on the Bonds.

## **ARTICLE I REPRESENTATIONS**

Section 1.1 Obligor Representations and Covenants. The Obligor makes the following representations and warranties for the benefit and reliance of the Issuer, the Trustee and the Bank:

(a) The Obligor is a Delaware corporation and is duly organized, validly existing, and in good standing under the laws of the State. The Obligor (i) has full power and authority to own and/or lease the properties and assets associated with the Project and to equip and install the Project, and (ii) has full power and authority to execute and deliver the Agreement, the Reimbursement Agreement, the Placement Agreement, the Remarketing Agreement and the Pledge Agreement, and to perform the obligations as contemplated thereunder.

(b) Neither the execution and delivery of the Reimbursement Agreement, the Placement Agreement, the Remarketing Agreement, the Pledge Agreement or the Agreement, nor the consummation of the transactions contemplated thereby, nor the fulfillment of or compliance with the terms and conditions of the Reimbursement Agreement, the Placement Agreement, the Remarketing Agreement, the Pledge Agreement or the Agreement, will, to the best knowledge of the Obligor, violate the Charter or By-laws of the Obligor, any provision of law, any order of any court or other agency of government, or any indenture, agreement or other instrument to which the Obligor is now a party or by which it or any of its properties or assets is bound, or will be in conflict with, result in a breach of, or constitute a default (with due notice or the passage of time or both) under, any such indenture, agreement, or other instrument, the result of which conflict, breach or default would result in a material adverse affect on the Obligor.

(c) This Agreement, the Reimbursement Agreement, the Placement Agreement, the Remarketing Agreement, and the Pledge Agreement have been duly authorized, executed and delivered and are each valid and binding obligations of the Obligor enforceable in accordance with their terms, except as such enforceability may be limited by applicable bankruptcy, insolvency, reorganization, moratorium or other similar laws in effect from time to time affecting the enforceability of creditors' rights generally or by general principles of equity.

(d) The Obligor intends to operate the Project or cause the Project to be operated at all times during the term of the Agreement for Project Purposes and does not know of any reason why the Project will not be so used by it in the absence of supervening circumstance not now anticipated by it or beyond its control.

(e) The Project will be completed in such manner as to conform with all applicable zoning, planning, building and other regulations of governmental authorities having jurisdiction of the Project, all necessary utilities are or will be available to the Project, and the Obligor has obtained or will obtain all requisite zoning, planning, building, environmental or other permits necessary for the construction and installation of the Project for Project Purposes, and additional permits necessary for the use of the Project are expected to be obtained upon application at the appropriate times.

(f) The Obligor's estimates of Project Costs, the Completion Date and period of usefulness of the Project which were supplied to the Issuer have been made in good faith and are, to the best of the Obligor's knowledge, fair, reasonable and realistic.

(g) No litigation or governmental proceeding is pending or, to the best knowledge of the Obligor threatened against the Obligor which could have a material adverse effect on its financial condition or business, or its power to borrow or repay the Loan.

(h) The Obligor will operate the Project as an "economic development project" under the Act during the term of this Agreement. The Project qualifies as an "economic development project" under the Act.

(i) All the net Bond proceeds from the sale of the Bonds will be expended for Project Costs. No costs of the Project to be financed from the proceeds of the Bonds were paid for or incurred prior to 60 days before official action was taken by the Issuer on the Inducement Date. No portion of the Project has been placed in service prior to the Inducement Date.

(j) The Obligor expects to cause the Project to be utilized for distribution activities for the term the Bonds will be outstanding.

(k) No expenditures for the Project were made prior to 60 days before the Issuer adopted its official intent resolution for the Project on the Inducement Date.

Section 1.2 Intentionally Omitted.

Section 1.3 Issuer Representations.

(a) Based upon the advice of Bond Counsel, the Issuer has the necessary power under the Act, and has duly taken all action on its part required to authorize, execute and deliver the Agreement and to issue the Bonds. The execution and performance by the Issuer of its obligations under this Agreement will not violate or conflict with any instrument by which the Issuer or its properties are bound.

(b) All of the proceedings approving the Agreement and the Indenture relating to the Bonds were conducted by the Issuer at meetings which complied with the Mississippi Open Meetings Act.

(c) No member of the Board of Directors of the Issuer is directly or indirectly a party to or in any manner whatsoever interested in the Agreement, the Indenture, the Bonds or the proceedings related thereto.

Additional Bonds. At the request of the Obligor the Issuer may, but shall not be required to, authorize the issuance of the Additional Bonds in accordance with Section 112 of the Indenture. Additional Bonds shall not be issued without the prior written consent of the Bank. The terms of any Additional Bonds shall be approved in writing by the Obligor. Additional Bonds may be issued only to finance any one or more of the following: (i) the costs of making Improvements to the Project; (ii) the refunding of all or any part of the Bonds; and (iii) the Issuance Costs relating to the Additional Bonds and other costs reasonably related to the financing as



shall be agreed upon by the Obligor and the Issuer. Any Improvements to the Project acquired with the proceeds of the Additional Bonds shall become a part of the Project and shall be included under the Agreement. Refusal for any reason by the Issuer to issue Additional Bonds shall not release the Obligor from any provisions of the Agreement.

#### Section 1.4 Benefits Under the Act.

(a) The parties hereto acknowledge that the Obligor has been induced to proceed with the acquisition, equipping and installation of the Project in part by the benefits conferred by the Act. The Issuer hereby agrees that the Obligor shall be permitted to take advantage of all of the benefits provided by the Act to the fullest extent therein set forth subject to the rules and regulations of the Issuer and the provisions of the Act. The Issuer agrees that it will not take any action to limit, curtail or otherwise make unavailable to the Obligor any of the benefits available under the Act.

(b) With respect to benefits conferred by the Act referenced in (a) above, the following shall apply:

(i) the maximum benefits accruing in any calendar year with respect to the income tax credit (other than any credits which may be carried forward to future years pursuant to the Act) shall not exceed the payments of the principal of, premium, if any, and interest payments on the Bonds during such year, and the fees and expenses of the Trustee and any other fees and expenses referenced herein.

(ii) the deductibility of interest payments on the Bonds shall be determined in accordance with applicable Mississippi law.

(iii) the Obligor shall request the Trustee to provide the Issuer, not later than ninety (90) days after the end of each calendar year, with a certificate setting forth the amount of all payments made to the Trustee with respect to the Bonds whether for principal, premium, interest or the fees and expenses of the Trustee.

(c) the benefits accruing to the Obligor under this Section 1.5 shall cease in the event:

(i) a Default should occur under this Agreement or an Event of Default should occur under the Indenture; or

(ii) the Obligor should fail to operate the Project for a period of nine (9) consecutive months following the initial start up of the Project except for force majeure, strikes, lockouts, damage, destruction, act of God, act of terrorism or in general, reasons beyond the Obligor's reasonable control excepting, however, general economic conditions.

(d) the Obligor agrees to comply with the terms and provisions of the Act in all respects with respect to the benefits available under the Act.

(e) the benefits or credits available under the Act shall cease to accrue on the date the principal and interest on the Bonds are paid in full whether at maturity or by way of redemption, except for any carryforward available under the Act.

(f) the benefits accruing to the Obligor under this Section 1.5 shall be limited to the annual debt service payments on the Bonds for qualified Project Costs and shall be reduced by the amount of surplus funds remaining after completion which shall be used to redeem Bonds as provided for in Section 4.4 of this Agreement.

(g) the tax credits allowed as a benefit under the Act shall be further limited so that the credits allowed in any year shall not exceed eighty percent (80%) of the amount of taxes due to the State prior to the application of the credits (as directed in Section 27-7-22.3, Mississippi Code of 1972, as amended). To the extent that the payments of the principal of, premium, if any, and interest payments on the Bonds during any year and the fees and expenses of the Trustee and any other fees and expenses referenced herein exceed the amount of the tax credit authorized by Section 27-7-22.3, Mississippi Code of 1972, as amended, in any taxable year, such excess payment may be recouped from excess credits in succeeding years not to exceed three (3) years following the date upon which the credit was earned.

The Issuer makes no warranty or guaranty concerning the availability or application of the benefits granted or earned by the Obligor under this Section 1.5 or the Act.

## **ARTICLE II THE BONDS AND THE PROCEEDS THEREOF**

Section 2.1 The Bonds. The Issuer has authorized the issuance and sale of the Bonds. Upon issuance and delivery, the proceeds of the sale of the Bonds derived by the Issuer shall be deposited with the Trustee as follows: (a) in the Bond Fund, a sum equal to the accrued interest, if any, on the Bonds and (b) in the Project Fund the balance of the proceeds of the Bonds. The obligations of the Issuer and the Obligor under the Agreement are expressly conditioned upon delivery of the Bonds and receipt of the proceeds thereof.

Section 2.2 Issuer Action on Redemption. The Issuer shall, at the request of the Obligor in the case of an optional redemption or at the request of the Trustee in the case of a mandatory redemption on expiration of the Credit Facility, or mandatory redemption from Surplus Bond Proceeds, forthwith take all steps as may be necessary under the Indenture to effect the earliest practicable redemption, as provided under the Indenture, of any or all of the Bonds or portions thereof as may be specified by the Obligor or Trustee, as the case may be.

In the event of an optional redemption, mandatory redemption from Surplus Bond Proceeds (as defined in Section 4.4 hereof) or mandatory redemption on expiration of the Credit Facility, unless such redemption is effected in connection with a refunding, the Obligor will pay or cause to be paid pursuant to a draw on the Credit Facility (or, with respect to any premium, if premium is not covered by the Credit Facility, with Available Moneys) an amount equal to the

applicable redemption price as a prepayment of the principal amount of the Loan corresponding to such Bonds or portions thereof, together with premium, if any, and interest accrued to the redemption date.

In the case of an Extraordinary Optional Redemption, the Obligor's direction to the Issuer to redeem shall be given, if at all, within six months following the occurrence of the event giving rise to such redemption.

**Section 2.3 Investment of Bond Fund and Project Fund.** Any moneys held as part of the Bond Fund or Project Fund shall be invested, reinvested or applied by the Trustee in accordance with and subject to the conditions of Article VII of the Indenture. The Obligor acknowledges that regulations of the Comptroller of the Currency grant the Obligor the right to receive brokerage confirmations of the security transactions as they occur. The Obligor specifically waives such notification to the extent permitted by law and will receive periodic cash transaction statements which will detail all investment transactions.

**Section 2.4 Credit Facility.** The Obligor shall cause the Credit Facility to be delivered to the Trustee on or before the Effective Date. The Credit Facility shall (a) be in an amount equal to the aggregate principal amount of the Bonds outstanding from time to time plus 45 days' (or if required pursuant to Section 208 of the Indenture, 210 days') interest thereon calculated at the Maximum Rate, plus premium, if any; (b) provide for payment to the extent of the amount specified in the preceding clause (a) in immediately available funds to the Trustee (upon receipt of the Trustee's request for payment of the principal of, premium, if any, and/or interest on the Bonds then outstanding on any Bond Payment Date, proposed Conversion Date, Conversion Date, Substitution Date, Purchase Date or redemption date pursuant to the Indenture); and (c) provide an expiration date no earlier than the earliest of (i) the payment in full by the Bank of funds authorized to be drawn thereunder so that there are no Outstanding Bonds, (ii) the honoring by the Bank of a draft on the Credit Facility for all Outstanding Bonds, (iii) a stated expiration date, (iv) the day after any Fixed Rate Conversion Date if the Obligor so elects, or (v) the fifteenth day following an Event of Default pursuant to Section 801(d) of the Indenture. The Obligor will cause any extension of the Credit Facility to be deposited by the Bank with the Trustee at least 60 days prior to the last Interest Payment Date prior to the expiration of the Credit Facility or Substitute Credit Facility then in effect. Each extension of the Credit Facility shall be satisfactory in form and substance to the Trustee. Following the Fixed Rate Conversion Date, the Bonds may, but need not, be secured by a Credit Facility. The Obligor shall have the right to provide a Substitute Credit Facility in accordance with Section 210 of the Indenture.

**Section 2.5 Tender.** The Issuer agrees to cause the Trustee in the Indenture to act as tender agent for the Obligor in connection with certain tenders of Variable Rate Bonds and as tender agent for the Bank in connection with certain other tenders of Variable Rate Bonds, all as provided in Article II of the Indenture.

**Section 2.6 Remarketing Agent.** The Obligor hereby approves of the appointment of Comerica Securities, as the initial Remarketing Agent and further covenants and agrees that without prior written notice to the Trustee, and without written approval by the Bank which approval shall not be unreasonably withheld, it will not change the Remarketing Agent.

Section 2.7 Right to Exercise Conversion Option. Subject to the ability of the Obligor to satisfy certain conditions described in the Indenture, the right is reserved to the Obligor, upon receipt of prior approval from the Bank (but only if the existing Credit Facility will remain in effect following the proposed conversion or, in any event, if a draw may be made on the existing Credit Facility in connection with the proposed conversion), to exercise the conversion option in accordance with the Indenture.

### **ARTICLE III THE LOAN AND LOAN REPAYMENTS**

Section 3.1 The Loan. Concurrently with the delivery of the Bonds, the Issuer will, upon the terms and conditions of the Agreement, lend to the Obligor, by deposit of the proceeds thereof with the Trustee in the Project Fund, an amount equal to the principal amount of the Bonds for application to Project Costs. The accrued interest, if any, received by the Issuer upon the sale of the Bonds shall be deposited into the Bond Fund and shall be applied to the first interest due on such Bonds.

Section 3.2 Loan Repayments; Credit Facility. Except as hereinafter provided, the Obligor shall pay or cause to be paid, in immediately available funds, to the Trustee, for the account of the Issuer, loan repayments corresponding to the principal, premium, if any, purchase price and interest payments on the Bonds (the "Loan Repayments"); in lieu of such payments, the Trustee shall draw on the Credit Facility, pursuant to Section 209 of the Indenture, amounts equal to such Loan Repayments. So long as the Credit Facility is in effect, the Loan Repayments representing principal of, premium, if any, and interest payments on the Bonds shall be made from deposits of the proceeds of drawings under the Credit Facility and the Obligor shall reimburse the Bank in accordance with the Reimbursement Agreement. The Obligor shall pay or cause to be paid Loan Repayments in installments equal to (a) the principal of the Bonds maturing or subject to redemption on any Bond Payment Date, (b) the interest on the Bonds at the interest rate then in effect, due on each Bond Payment Date and (c) any premium required to be paid on the Bonds.

Payments of the principal of, premium, if any, or interest on the Bonds shall be made solely from the Security, including draws under the Credit Facility (except with respect to premium, unless the Credit Facility has been amended to cover premium on the Bonds). The Obligor's obligation to make Loan Repayments is and shall remain unconditional regardless of the sufficiency and availability of Available Moneys to make such payments.

With written notice to the Issuer, the Bank and the Trustee, the Obligor may prepay in whole or in part amounts due on account of the Loan Repayments or for the redemption of Bonds prior to maturity or purchase, but such prepayment shall not in any way alter or suspend any of the obligations of the Obligor under the terms of the Agreement and the Obligor shall continue to perform and be responsible for the performance of all other terms and provisions. Such notice shall be given at least 10 Business Days before the Trustee is to give notice of any related redemption pursuant to Article IV of the Indenture. The Issuer agrees that the Trustee may accept such prepayments when the same are tendered by the Obligor and that such prepayments may be directed by the Obligor to be used for credit on Loan Repayments or for the

redemption or purchase of Bonds in the manner and to the extent provided herein and in the Indenture.

In the event the Obligor prepays Loan Repayments in the following manner and in accordance with the provisions of the Indenture: (a) in Available Moneys, after delivering the No Act of Bankruptcy Certificate attached hereto as Exhibit D to the Trustee or (b) by causing the Trustee to draw on the Credit Facility, for deposit in the Bond Fund in an amount of money (or in any other manner satisfactory to the Trustee) which, together with amounts then on deposit in the Bond Fund and available therefor, shall be sufficient (i) to retire and redeem at the earliest date(s) permitted under the Indenture all of the then Bonds outstanding and (ii) to pay any interest accruing on the Bonds to maturity or redemption, and shall also make provision satisfactory to the Issuer and the Trustee for all fees, costs and expenses specified in Article V hereof accruing through the final payment of the Bonds, then the Loan shall be deemed fully repaid and canceled, and the lien of the Indenture shall be discharged, except for the provisions providing for payment of principal of, premium, if any, and interest to the Bondholders.

#### **ARTICLE IV INSTALLATION OF THE PROJECT**

Section 4.1 Project Fund Disbursements. There is established with the Trustee under the Indenture the Project Fund, the moneys in which, subject to the terms hereof and of the Indenture, and subject to the security interest therein granted by the Obligor to the Issuer, shall be the property of the Obligor. Unless an Event of Default has occurred and is continuing which the Trustee is required to take notice of or is deemed to have notice of pursuant to

Section 901(h) of the Indenture, the Trustee, as authorized by the Indenture, shall disburse to or for the benefit of the Obligor out of the Project Fund the lesser of (a) the Project Costs, or (b) the proceeds of the Bonds deposited in the Project Fund and investment income in the Project Fund. Such disbursements shall be made from time to time to pay Project Costs, so long as there are moneys in the Project Fund, upon presentation of Requisition Certificate(s) executed by the Obligor and approved for payment in writing by the Bank. The Trustee may also disburse moneys out of the Project Fund to or for the benefit of the Issuer upon the Obligor's failure to pay the fees, costs and expenses of the Trustee or Issuance Costs as required by Section 5.2 hereof.

Disbursements from the Project Fund shall be made upon the Trustee's receipt of an executed and approved Requisition Certificate.

The Obligor shall also deliver or cause to be delivered to the Trustee with a Requisition Certificate such other documents and certificates as may be required by the Bank, it being understood that the Trustee shall have no duty to review such documents and certificates nor shall it be required to approve same.

Upon the occurrence of an Event of Default under the Indenture, any moneys in the Project Fund shall be transferred by the Trustee to the Bond Fund.

Upon request and with reasonable notice, the Obligor shall permit the Trustee or the Issuer or its authorized agents to audit the records of the Obligor relating to Project Costs during normal business hours.

Section 4.2 Obligation of the Obligor to Complete the Project. The Obligor shall proceed with reasonable dispatch to complete the Project.

The Issuer makes no warranty, either express or implied, and offers no assurance as to the condition of the Project or that the Project is or will be suitable for the Obligor's purposes, or that the proceeds derived from the sale of the Bonds will be sufficient to pay all Project Costs, and the Issuer shall not be liable to the Obligor if for any reason the Project is not completed. In the event moneys in the Project Fund are insufficient to pay all Project Costs, the Obligor will complete the Project and pay the Project Costs in excess of the sum of moneys available in the Project Fund. By reason of the payment of any such portion of the Project Costs, the Obligor shall not be entitled to any reimbursement from the Issuer, the Trustee or the holders of the Bonds in respect thereof or to any diminution or abatement in the Loan Repayments payable under the Agreement.

Section 4.3 Completion Certificate. The Obligor shall as promptly as practicable file with the Trustee, the Issuer and the Bank a certificate substantially in the form of Exhibit C attached hereto when the Project is complete. All moneys deposited in the Project Fund and not needed, as of the Completion Date, to pay or reimburse Project Costs (which money shall be used for such purposes if needed), shall, upon receipt of such certificate, and in any event on the third anniversary hereof be deemed Surplus Bond Proceeds and shall be immediately transferred to the Bond Fund to be applied by the Trustee in the manner provided in Section 4.4 of this Agreement.

Section 4.4 Use of Surplus Bond Proceeds. All moneys transferred to the Bond Fund pursuant to the provisions of Section 4.3, Section 6.1 and Article VII hereof ("Surplus Bond Proceeds") shall be applied by the Trustee for redemption of the Bonds pursuant to mandatory redemption from Surplus Bond Proceeds or Extraordinary Optional Redemption, as the case may be, as provided in the Bond Form Appendix to the Indenture or reimbursement of the Bank for honoring a drawing under the Credit Facility for such purpose, or may be used for any other purpose approved in writing by the Bank which is permitted by the Act.

In no event shall Surplus Bond Proceeds so transferred to the Bond Fund or the investment income thereon be used to pay interest on the Bonds.

## **ARTICLE V OTHER PECUNIARY OBLIGATIONS OF THE OBLIGOR**

Section 5.1 Taxes and Other Costs. The Obligor shall promptly pay, as the same become due, all lawful taxes and governmental charges of any kind whatsoever, including without limitation income, profits, receipts, business, property and excise taxes, with respect to any estate, interest, documentation or transfer in or of the Project, the Agreement, the Loan or any payments with respect to the foregoing, the costs of all building and other permits to be procured, and all utility and other charges and costs incurred in the operation, maintenance, use and upkeep of the Project. The Obligor shall furnish the Issuer upon request proof of payment of any such taxes, charges or costs. The Obligor may in good faith contest, and during such contest not pay, any such taxes, charges and costs, unless limited by and subject to the restrictions provided in the Reimbursement Agreement. The parties acknowledge that the Project will be

subject to ad valorem taxation unless the appropriate local taxing authorities (County and City governing bodies) agree that the Project will be exempt in whole or in part from such taxes.

**Section 5.2 Issuer Fees and Expenses.** The Obligor shall pay all Issuance Costs and other reasonable out-of-pocket costs and expenses of the Issuer incidental to the performance of its obligations under the Agreement, the Indenture and with respect to its authorization, sale and delivery of the Bonds, including without limitation on or before the Effective Date the Issuer's Issuance Fee, or reasonably incurred by the Issuer in enforcing the provisions of the Agreement or the Indenture.

**Section 5.3 Fees and Expenses of the Trustee and Remarketing Agent.** The Obligor shall pay the reasonable fees, costs and expenses and advances of the Trustee, and the Remarketing Agent under the Indenture for services rendered in connection with the Bonds, the duties and services of such Trustee being set out in the Indenture, and it shall pay the Trustee, in addition, all reasonable out-of-pocket counsel fees, taxes and other fees, costs and expenses reasonably incurred by the Trustee in performing its duties as Trustee and in entering into the Indenture. All such payments shall be made as statements are rendered and shall be made by the Obligor directly to the Trustee except to the extent fees and expenses of the Trustee incurred in connection with the issuance of the Bonds are paid from proceeds of sale of the Bonds.

#### **Section 5.4 Indemnification of the Issuer**

(a) The "Indemnified Persons" shall not be liable to the Obligor for any reason in connection with the issuance of the Bonds. The Obligor shall indemnify and hold the Issuer and the Indemnified Persons harmless from any loss, expense (including reasonable counsel fees), or liability of any nature due to any and all suits, actions, legal or administrative proceedings, or claims arising or resulting from, or in any way connected with:

(i) the financing, installation, operation, use, or maintenance of the Project,

(ii) any act, failure to act, or misrepresentation by any person, firm, corporation or governmental agency, including the Issuer, in connection with the issuance, sale, remarketing or delivery of the Bonds,

(iii) any act, failure to act, or misrepresentation by the Issuer in connection with this Agreement or any other document involving the Issuer in this matter, or

(iv) the selection and appointment of firms providing services to the Bond transaction.

If any suit, action or proceeding is brought against the Issuer or any Indemnified Person, that action or proceeding shall be defended by counsel to the Issuer or the Obligor, as the Issuer shall determine. If the defense is by counsel to the Issuer which is the Attorney General of the State, or may in some instances be private, retained counsel to the Issuer but which counsel shall not

have an existing conflict of interest with the Obligor in undertaking the representation, the Obligor shall indemnify the Issuer and Indemnified Persons for the reasonable cost of that defense including reasonable counsel fees. If the Issuer determines that the Obligor shall defend the Issuer or Indemnified Person, the Obligor shall immediately assume the defense at its own cost. The Obligor shall not be liable for any settlement of any proceedings made without its consent (which consent shall not be unreasonably withheld).

(b) The Obligor shall also indemnify the Issuer for all reasonable costs and expenses, including reasonable counsel fees, incurred in:

(i) enforcing any obligation of the Obligor under this Agreement or any related agreement,

(ii) taking any action requested by the Obligor,

(iii) taking action required by this Agreement or any related agreement, or

(iv) taking any action considered necessary by the Issuer and which is authorized by this Agreement or any related agreement.

(c) The obligations of the Obligor under this section shall survive any assignment or termination of this Agreement.

(d) The Obligor shall not be obligated to indemnify the Issuer or any Indemnified Person under subsection (a), if a court with competent jurisdiction finds that the liability in question was caused by the willful misconduct or sole gross negligence of the Issuer or the involved Indemnified Person(s), unless the court determines that, despite the adjudication of liability but in view of all circumstances of the case, the Issuer or the Indemnified Person(s) is (are) fairly and reasonably entitled to indemnity for the expenses which the court considers proper.

**Section 5.5 Indemnification of the Trustee.** The Obligor shall indemnify and hold the Trustee harmless against any loss, liability or expense, including reasonable attorneys' fees, or costs incurred without breach of the required standard of care set forth in the Indenture arising out of or in connection with claims or actions taken under or pursuant to the Indenture, including the costs and expenses of defense including counsel selected by the Trustee against any such claim or action or liability. Notwithstanding anything to the contrary in this Agreement, the Obligor expressly acknowledges and agrees that the obligations and liabilities of the Obligor as set forth in this Section 5.5 shall survive the resignation or removal of the Trustee.

**Section 5.6 Insurance.** The Obligor shall continuously insure against such risks and in such amounts as are required under the Reimbursement Agreement.



**ARTICLE VI  
PROJECT MAINTENANCE**

Section 6.1 Maintenance and Operation. The Obligor, at its expense, shall maintain the Project in good condition, repair and working order, and shall make or cause to be made from time to time all necessary repairs, renewals and replacements, ordinary wear and tear and obsolescence excepted.

Section 6.2 Remodeling and Modifications. The Obligor may remodel or modify the Project as it, in its discretion, may deem to be desirable for its uses and purposes. The cost of such remodeling, modifications or improvements shall be paid by the Obligor.

**ARTICLE VII  
DAMAGE TO PROJECT AND CONDEMNATION**

In the event (i) the Project is damaged or destroyed, or (ii) failure of title to all or part of the Project occurs or title to or temporary use of the Project is taken in condemnation or by the exercise of the power of eminent domain by any governmental body or by any person, firm or corporation acting under governmental authority, the Obligor shall promptly give written notice thereof to the Issuer, the Trustee and, if the Credit Facility is in effect at the time, the Bank. As soon as practicable the Obligor shall elect in writing to the Issuer, the Bank and the Trustee, and with the written consent of the Bank as required by the Reimbursement Agreement (or the Collateral Documents, as defined in the Reimbursement Agreement), whether to deposit insurance or condemnation proceeds in the Project Fund or in the Bond Fund. If the Obligor shall elect to deposit such proceeds in the Project Fund, it shall proceed to restore the Project with reasonable dispatch, and such moneys shall be disbursed in accordance with Section 4.1 of this Agreement. If the Obligor shall elect to deposit such proceeds in the Surplus Bond Proceeds Account in the Bond Fund, such proceeds shall be used to redeem the Bonds to the extent of such proceeds in the manner provided in the Indenture and in the Bond Forms Appendix under Mandatory Redemption from Surplus Bond Proceeds. As long as any of the Bonds are outstanding, all such funds shall be invested as directed by the Obligor.

**ARTICLE VIII  
ACTIONS AFFECTING OBLIGOR AND ISSUER INTERESTS IN THE  
AGREEMENT AND THE PROJECT**

Section 8.1 Assignment of the Agreement. The Issuer shall assign its rights under and interest in the Agreement (except Reserved Rights) and in all moneys deposited in the various funds under the Agreement and the Indenture to the Trustee pursuant to the Indenture as security for payment of the principal of and interest on the Bonds, and such assignment shall entitle the Trustee to enforce any obligation of the Obligor under the Agreement. The Obligor hereby consents to any and all assignments described in the preceding sentence or set forth in the Indenture. The Issuer shall not amend the Indenture without the written consent of the Obligor, the Trustee and the Bank, as provided in the Indenture.

Pursuant to the Act, the assignment of the Issuer's rights and interests pursuant to this Section 8.1 shall be valid and binding from the time this assignment is made. The money or

property pledged and thereafter received by the Issuer immediately shall be subject to a lien in favor of the Trustee without a physical delivery, filing, or any further act. The lien of the Trustee shall be valid or binding as against parties having claims of any kind in tort, contract, or otherwise, against the Issuer irrespective of whether the parties have notice. Neither this Agreement, the Indenture, nor any other instrument by which the assignment is made need be filed or recorded.

Section 8.2 Obligor's Interest in the Agreement. The Obligor shall not assign or transfer its rights or obligations under the Agreement, except as permitted in the Agreement or consented to in writing by the Bank (which consent shall be governed by the Reimbursement Agreement) and as long as the General Limitations are complied with.

Section 8.3 Liens by the Obligor. The Obligor shall not create or permit the creation of any lien, encumbrance or charge upon the Project except Permitted Encumbrances.

Section 8.4 Security Interest in the Project Fund. To better secure its obligations hereunder, including the obligation to pay Loan Repayments, as and when they are due, the Obligor hereby grants a security interest in the moneys at any time held in the Project Fund, and any proceeds thereof, to the Issuer and the Bank (to the extent the Trustee is directed to disburse such moneys to the Bank pursuant to the Indenture) to be perfected by possession of such moneys in the Project Fund by the Trustee and held therein for the benefit of the Bondholders and Bank as provided in the Indenture.

Section 8.5 Ownership of Project. The parties acknowledge that the Obligor leases the real property on which the Project will be located, and that the Obligor shall own the Project (which may constitute leasehold improvements to such real property).

## **ARTICLE IX FURTHER OBLIGATIONS OF THE OBLIGOR**

Section 9.1 Compliance with Laws. The Obligor shall, throughout the term of the Agreement and at no expense to the Issuer, promptly comply or cause compliance with all legal requirements of duly constituted public authorities which are applicable to the Project or to the repair and alteration thereof, or to the use or manner of use of the Project. Notwithstanding the foregoing, but subject to the General Limitations, the Obligor may exercise its rights to contest the legality of any such legal requirement as applied to the Project provided that in the opinion of Counsel such contest shall not in any way materially adversely affect or impair the obligations of the Obligor under the Agreement.

Section 9.2 Ownership of Project.

(a) So long as no Event of Default shall have occurred and be continuing hereunder, the Project may be conveyed and transferred and this Agreement assigned to a new owner with the prior written consent of the Issuer and the Bank (which consent shall be governed by the Reimbursement Agreement), and without the consent of the Trustee or any Bondholder; provided that (i) the new owner shall be an individual, a partnership, limited liability company or corporation duly organized and validly existing in good standing under the laws of any state and, if applicable, is qualified to do business in

Mississippi and shall assume in writing the obligations of the Obligor under this Agreement and the other documents contemplated hereby and (ii) the Obligor shall, at least 30 days prior to any such assignment or transfer, provide the Issuer and the Trustee with written notice of such transfer accompanied by a copy of the assumption agreement.

(b) The Obligor shall at all times operate or cause to be operated the Project in strict compliance with the terms of this Agreement so that it fulfills the public purposes of the Act.

Section 9.3 Access to Project and Records. Subject to reasonable security and safety regulations and reasonable requirements as to notice, the Issuer, the Trustee, the Bank and their duly authorized agents shall have the right at all reasonable times to enter the facility of the Obligor and inspect the Project. The Issuer, the Trustee, the Bank and their duly authorized agents shall also have the right to inspect the books and records of the Obligor pertaining to the Project and the Security (as defined in the Indenture), subject to reasonable requirements as to notice and during regular business hours.

## **ARTICLE X EVENTS OF DEFAULT AND REMEDIES**

Section 10.1 Events of Default. The term "Event of Default" shall mean, whenever used in the Agreement, any one or more of the following events:

- (a) Failure by the Obligor to pay any Loan Repayments in the amounts and at the times provided in the Agreement, but if and only if the Bank has, after demand under the Credit Facility, failed to pay the amount of such Loan Repayment as and when due.
- (b) Failure by the Obligor to observe and perform any other obligations in this Agreement on its part to be observed or performed for a period of 30 days after written notice specifying such failure and requesting that it be remedied, given to the Obligor by the Issuer, the Bank or the Trustee; provided, however, that if such Default shall be such that it cannot be corrected within such period, it shall not constitute an Event of Default if correctable without material adverse effect on the Bonds and if corrective action is instituted by the Obligor within such period and is diligently pursued until corrected.
- (c) Any representation or warranty made by the Obligor in any document delivered by the Obligor to the initial purchasers, the Trustee, the Bank or the Issuer in connection with the issuance, sale and delivery of the Bonds is untrue when made in any material adverse respect.
- (d) The occurrence of an Event of Default under the Indenture.
- (e) Notice from the Bank of the occurrence of an Event of Default under the Reimbursement Agreement.

The Events of Default described in subsection (b) above are also subject to the following limitation: If the Obligor by reason of force majeure is unable to carry out or observe the obligations described in such subsection (b), the Obligor shall not be deemed to be in breach or

violation of this Agreement during the continuance of such inability. The term "force majeure" as used herein shall include, without limitation, acts of public enemies; insurrections; riots; epidemics; landslides; lightning; earthquake; fire; hurricanes; tornadoes; storms; floods; washouts; droughts; arrests; civil disturbances; labor disturbances or strikes; explosions; breakage or accident to machinery, transmission pipes or canals; partial or entire failure of utilities; or any other cause or event other than financial inability not reasonably within the control of the Obligor. The Obligor agrees, however, insofar as possible to remedy with all reasonable dispatch the causes preventing it from carrying out its agreement; provided, however, that the settlement of strikes, lockouts and other industrial disturbances shall be entirely within the exercise of the reasonable discretion of the Obligor.

Section 10.2 Remedies upon Event of Default. Whenever any Event of Default shall have occurred and be continuing, the Issuer, with the consent of the Trustee, or the Trustee acting alone, shall have and may exercise any one or more of the following remedial powers:

(a) If the principal of and interest accrued on the Bonds shall have been declared immediately due and payable pursuant to the Indenture, to declare all Loan Repayments payable under Section 3.2 for the remainder of the term of the Agreement to be immediately due and payable, whereupon the same shall become immediately due and payable; provided, however, that if the Trustee shall annul any such declaration pursuant to the Indenture, the declaration provided for in this clause (a) shall be deemed annulled;

(b) If the principal of and interest accrued on the Bonds shall have been declared immediately due and payable pursuant to the Indenture, to institute any actions or proceedings at law or in equity for the collection of Loan Repayments or other sums due and unpaid under the Agreement, to prosecute any such action or proceeding to judgment or final decree, and to enforce any such judgment or final decree and collect in the manner provided by law any moneys adjudged or decreed to be payable;

(c) In case there shall be pending proceedings for the bankruptcy or for the reorganization of the Obligor under the Federal bankruptcy laws or any other applicable law, or in case a receiver or trustee shall have been appointed for the property of the Obligor, to file and prove a claim or claims for the whole amount owing under the Agreement plus interest owing and unpaid in respect thereof and, in case of any judicial proceedings, to file such proofs of claim and other papers or documents as may be necessary or advisable in order to have the claims of the Trustee allowed in such judicial proceedings relative to the Obligor, its creditors, or its property, and to collect and receive any moneys or other property payable or deliverable on any such claims, and to distribute the same after the deduction of its charges and expenses.

In case the Trustee or the Issuer shall have proceeded to exercise or enforce any right or remedy under the Agreement and such proceeding shall have been discontinued or abandoned for any reason, or shall have been determined adversely, then and in every such case, the Obligor, the Issuer and the Trustee shall be restored to its respective rights and positions hereunder and all rights and remedies of the Obligor, the Issuer and the Trustee shall continue as though no such proceeding had been taken, but subject to the limitations of any such adverse determination.

Any amounts collected pursuant to action taken under this Section shall be paid into the Bond Fund and applied in accordance with the Indenture, except amounts collected pursuant to Article V for the benefit of the Issuer or the Issuer's Agents, which shall be paid to and retained by the Issuer.

Section 10.3 Payment of Attorneys' Fees and Other Expenses. In the event the Obligor should default under any of the provisions of the Agreement and the Issuer and/or the Trustee should employ attorneys or incur other expenses for the collection of the Loan or for the enforcement of performance or observance of any obligation of the Obligor in the Agreement or any other document related to the issuance of and security for the Bonds, the Obligor shall on demand therefor pay to the Issuer or the Trustee, or both, as the case may be, the reasonable fees of such attorneys and such other reasonable expenses so incurred.

Section 10.4 Waivers and Limitation on Waivers. By reason of the assignment of the Issuer's rights and interest in the Agreement to the Trustee, the Trustee shall have the power with the consent of the Bank to, and shall if requested by the Bank, waive or release the Obligor from any Event of Default or the performance or observance of any obligation or condition of the Obligor under the Agreement, provided such waiver or release is not prohibited by the Indenture and the Trustee and the Issuer receive an opinion of Counsel that such action will not impose any pecuniary obligation or liability or adverse consequence upon the Issuer or the Trustee and the Issuer and the Trustee shall have each been provided such indemnification from the Obligor as the Issuer or the Trustee shall deem necessary, and provided that, with respect to a waiver of an Event of Default such waiver shall be limited to the particular Event of Default so waived and shall not be deemed to waive any other Event of Default hereunder nor a waiver of a similar Event of Default on a future occasion.

No delay or omission to exercise any right occurring upon any Event of Default shall impair any such right or shall be construed to be a waiver thereof, but any such right may be exercised from time to time and as often as may be deemed expedient. In order to exercise any remedy reserved to the Issuer or the Trustee in this Agreement, it shall not be necessary to give any notice other than such notice as may be herein expressly required. Notwithstanding anything to the contrary contained herein, the Obligor does not waive any statute of limitations under applicable law.

## **ARTICLE XI OBLIGATIONS OF OBLIGOR UNCONDITIONAL**

Section 11.1 Obligor Obligations. The obligation of the Obligor to make Loan Repayments as provided in Article III hereof and the payments required by Article V hereof and to perform its other covenants hereunder shall be absolute and unconditional and shall not be subject to any diminution by right of set-off, counterclaim, recoupment or otherwise. During the term hereof, the Obligor (i) shall not suspend or discontinue its Loan Repayments, (ii) shall perform and observe all of its other obligations contained herein and (iii) except as explicitly permitted herein, shall not terminate the Agreement for any cause including, without limiting the generality of the foregoing, defect in title to the Project, failure to complete the Project, any acts or circumstances that may constitute failure of consideration, eviction or constructive eviction, destruction or damage to or condemnation of the Project, commercial frustration of purpose, any

change in the tax or other law by the United States of America or the State or any political subdivision of either, or any failure of the Issuer to perform and observe any obligation or condition arising out of or connected with the Agreement. This shall not be construed to release the Issuer from the performance of any of its obligations under the Agreement; and in the event the Issuer shall fail to perform any such obligation, the Obligor may institute such action against the Issuer as the Obligor may deem necessary to compel performance; provided, however, that no such action shall violate this Section or diminish Loan Repayments. The Obligor may at its own cost and expense and in its own name or in the name of the Issuer, prosecute or defend any action or proceedings or take any other action involving third persons which the Obligor deems reasonably necessary in order to secure or protect its rights under the Agreement, and in such event the Issuer shall cooperate fully with the Obligor.

## **ARTICLE XII MISCELLANEOUS**

**Section 12.1 Amounts Remaining in Funds.** Any amounts remaining in the Bond Fund, the Purchase Fund or the Project Fund upon expiration or sooner termination of the Agreement as herein provided, after payment in full of the Bonds (or provision therefor) in accordance with the Indenture, and all other costs and expenses of the Obligor specified under Article V, and all amounts owing the Issuer, the Trustee, the Bank, and the Remarketing Agent under the Agreement, the Indenture and the Reimbursement Agreement, shall be paid to the Obligor.

**Section 12.2 Obligor Bound by Indenture.** The Indenture has been submitted to the Obligor for examination, and the Obligor, by execution of this Agreement, acknowledges and agrees that it has participated in the drafting of the Indenture and agrees that it has approved the Indenture and agrees that it is bound by and shall have the rights set forth by the terms and conditions thereof and covenants and agrees to perform all obligations required of the Obligor pursuant to the terms of the Indenture.

**Section 12.3 Consents Under the Agreement.** Unless otherwise expressly provided herein, all consents permitted or required to be given under the Agreement by the Issuer or the Trustee shall be reasonable and shall not be unreasonably withheld or delayed.

**Section 12.4 Notices.** All notices, certificates or other communications hereunder shall be sufficiently given and shall be deemed given on the date shown as delivered when mailed by registered or certified mail, postage prepaid, return receipt requested, addressed to the Issuer, the Obligor, the Bank, or the Trustee, as the case may be, at the Issuer's Address, the Obligor's Address, the Bank's Address, or the Trustee's Address, respectively, or hand delivered to the above at its respective addresses. A duplicate copy of each such notice, certificate or other communication given hereunder to the Issuer, the Obligor, the Bank, or the Trustee shall also be given to the others.

The Issuer, the Obligor, the Bank, and the Trustee may by written notice to the other parties, designate any further or different addresses to which subsequent notices, certificates or communications shall be sent.

Section 12.5 Amendment. The Agreement may be amended only as provided in the Indenture, and no amendment to the Agreement shall be binding upon either party hereto until such amendment is reduced to writing and executed by the parties hereto.

Section 12.6 Binding Effect. The Agreement shall be binding upon the parties hereto and upon its respective successors and assigns, and the words "Issuer" and "Obligor" shall include the parties hereto and its respective successors and assigns and include any gender, singular and plural, any individuals, partnerships or corporations.

Section 12.7 Severability. If any clause, provision or section of the Agreement be ruled invalid or unenforceable by any court of competent jurisdiction, the invalidity or unenforceability of such clause, provision or section shall not affect any of the remaining clauses, provisions or sections.

Section 12.8 Execution in Counterparts. The Agreement may be executed in several counterparts, each of which shall be an original and all of which shall constitute but one and the same instrument.

Section 12.9 Captions and Table of Contents. The captions or headings and the Table of Contents in the Agreement are for convenience only and in no way define, limit or describe the scope or intent of any provisions of the Agreement.

Section 12.10 Applicable Law. The Agreement shall be governed in all respects, whether as to validity, construction, performance or otherwise, by the laws of the State.

Section 12.11 Rights of the Bank. Anything contained in this Agreement to the contrary notwithstanding, all rights of the Bank to give consents or approvals, to direct actions or otherwise exercise any rights or authority under this Agreement, shall be suspended if the Bank wrongfully dishonors a draft drawn under the Credit Facility, or the Credit Facility is for any reason unavailable to the Trustee for the benefit of the holders of the Bonds other than its expiration in accordance with its terms.

**[THIS SPACE INTENTIONALLY LEFT BLANK]**

IN WITNESS WHEREOF, the parties hereto have caused the Agreement to be duly executed as of the day and year first above written.

**MISSISSIPPI BUSINESS FINANCE  
CORPORATION**  
(Issuer)

By: \_\_\_\_\_  
Bill Barry

Its: Executive Director

**Attest:**

By: \_\_\_\_\_  
Vernon Smith, Secretary

(SEAL)

**PRIORITY FULFILLMENT SERVICES, INC.**  
(Obligor)

By: \_\_\_\_\_  
Its: \_\_\_\_\_



## **EXHIBIT A**

The Project, located at 8474 Market Place, Southaven, Mississippi 38671, consists of the acquisition and installation of machinery, equipment and fixtures with respect to a logistics and distribution facility leased to the Obligor. The real estate on which the Project is to be located is leased to the Obligor.

## EXHIBIT B

### REQUISITION CERTIFICATE

TO: U.S. Bank National Association, as Trustee

FROM: Priority Fulfillment Services, Inc. (the "Obligor")

SUBJECT: \$5,000,000 Mississippi Business Finance Corporation Taxable Variable  
Rate Demand Limited Obligation Revenue Bonds, Series 2004 (Priority  
Fulfillment Services, Inc. Project)

This represents Requisition Certificate No. \_\_\_\_\_ in the total amount of \$\_\_\_\_\_ to pay those costs of the Project detailed in the schedule attached.

The undersigned does certify that:

1. The expenditures for which moneys are requisitioned hereby represent proper charges against the Project Fund of the subject bond issue, have not been included in a previous requisition and have been properly recorded on the Obligor's books.
2. The moneys requisitioned hereby are not greater than those necessary to meet obligations due and payable or to reimburse the Obligor for its funds actually advanced for Project Costs and do not represent a reimbursement to the Obligor for working capital.
3. To the best of our knowledge, no Event of Default exists under the Agreement and nothing has occurred to the knowledge of the Obligor that would prevent the performance of its obligations under the Agreement.
4. In the event moneys in the Project Fund after payment of moneys herein requested are insufficient to pay Project Costs, the Obligor will pay such additional Project Costs as are incurred from such other funds which are available for such purpose.
5. All of the property acquired with the moneys hereby requested will be owned by the Obligor.
6. Delivered herewith are the following requested certificates, sworn statements, waivers of lien, surveys, invoices, architect's certificates and other documents:

Capitalized terms used herein have the meanings given them in the Trust Indenture for the Bonds.

Executed this \_\_\_\_ day of \_\_\_\_\_, 20\_\_.

**PRIORITY FULFILLMENT SERVICES, INC.**  
(Obligor)

By \_\_\_\_\_  
Its: \_\_\_\_\_

**APPROVED BY:**

**COMERICA BANK, as Issuer of the Credit Facility**

By \_\_\_\_\_  
Its: \_\_\_\_\_

**SCHEDULE TO REQUISITION CERTIFICATE NO. \_\_\_\_\_**

Payee and Address	Description of Property or Services Provided	Amount
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## EXHIBIT C

### COMPLETION CERTIFICATE

TO: U.S. Bank National Association, as Trustee

FROM: Priority Fulfillment Services, Inc. (the "Obligor")

SUBJECT: \$5,000,000 Mississippi Business Finance Corporation Taxable Variable  
Rate Demand Limited Obligation Revenue Bonds, Series 2004 (Priority  
Fulfillment Services, Inc. Project)

The undersigned does hereby certify:

1. The equipping and installation of the Project have been completed in accordance with the Plans and in such manner as to conform with all applicable zoning, planning and building regulations of the governmental authorities having jurisdiction of the Project, as of the date of this Certificate (the "Completion Date").
2. The Project Costs have been paid in full except for those not yet due and payable, or which are being contested, which are described below and for which moneys for payment thereof are being held in the Project Fund:

(a) Cost of the Project not yet due and payable:

Description	Amount
	\$ _____
TOTAL	\$ _____

(b) Payments being contested:

Description	Amount
	\$ _____
TOTAL	\$ _____

3. The moneys in the Project Fund in excess of the totals set forth in 2(a) and (b) above represent Surplus Bond Proceeds and the Trustee is hereby authorized and directed to apply such moneys pursuant to Section 4.4 of the Agreement.

4. No Event of Default has occurred under the Agreement or the Reimbursement Agreement nor has any event occurred which with the giving of notice or lapse of

time or both shall become such an Event of Default. Nothing has occurred to the knowledge of the Obligor that would prevent the performance of its obligations under the Agreement or the Reimbursement Agreement.

This certificate is given without prejudice to any rights against third parties which exist at the date hereof or which may subsequently come into being.

Capitalized terms used herein have the meanings given them in the Trust Indenture for the Bonds.

Executed this \_\_\_\_ day of \_\_\_\_\_, 200\_.

**PRIORITY FULFILLMENT SERVICES, INC.**  
(Obligor)

By \_\_\_\_\_  
Its: \_\_\_\_\_

**EXHIBIT D**

**NO ACT OF BANKRUPTCY CERTIFICATE**

TO: U.S. Bank National Association, as Trustee

FROM: Priority Fulfillment Services, Inc. (the "Obligor")

SUBJECT: \$5,000,000 Mississippi Business Finance Corporation Taxable Variable  
Rate Demand Limited Obligation Revenue Bonds, Series 2004 (Priority  
Fulfillment Services, Inc. Project)

The undersigned does hereby certify to the Trustee and the Bank that, during and prior to the period beginning \_\_\_\_\_ and continuing until the date hereof, no Act of Bankruptcy (as defined in that certain Loan Agreement, dated as of November 1, 2004, between the undersigned and the Mississippi Business Finance Corporation) shall have occurred.

The Obligor acknowledges that the Trustee and the Bank may conclusively rely on this Certificate.

Under penalties of perjury, this certificate has been executed this \_\_\_\_ day of \_\_\_\_\_, 200\_, by the Obligor.

**PRIORITY FULFILLMENT SERVICES, INC.**  
(Obligor)

By \_\_\_\_\_  
Its: \_\_\_\_\_

**PLACEMENT AGREEMENT**

**BETWEEN**

**PRIORITY FULFILLMENT SERVICES, INC.**  
(THE "OBLIGOR")

**AND**

**COMERICA SECURITIES**  
(THE "PLACEMENT AGENT")

**AND**

**MISSISSIPPI BUSINESS FINANCE CORPORATION**  
(THE "ISSUER")

**DATED AS OF NOVEMBER 1, 2004**

**RELATING TO**

**\$5,000,000**  
**MISSISSIPPI BUSINESS FINANCE CORPORATION**  
**TAXABLE VARIABLE RATE DEMAND LIMITED OBLIGATION**  
**REVENUE BONDS, SERIES 2004**  
(PRIORITY FULFILLMENT SERVICES, INC. PROJECT)

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## **PLACEMENT AGREEMENT**

\$5,000,000

Mississippi Business Finance Corporation

Taxable Variable Rate Demand Limited Obligation Revenue Bonds, Series 2004

(Priority Fulfillment Services, Inc. Project)

**Dated as of November 1, 2004**

### **PRIORITY FULFILLMENT SERVICES, INC.**

500 N. Central Expressway, Suite 500  
Plano, Texas 75074

### **MISSISSIPPI BUSINESS FINANCE CORPORATION**

735 Riverside Drive, Suite 300  
Jackson, Mississippi 39202

Ladies and Gentlemen:

At the request of Priority Fulfillment Services, Inc., a Delaware corporation (the "Obligor"), Comerica Securities (the "Placement Agent") has acted as your placement agent in connection with the initial placement with the purchasers (the "Purchasers") of \$5,000,000 aggregate principal amount of Mississippi Business Finance Corporation Taxable Variable Rate Demand Limited Obligation Revenue Bonds, Series 2004 (Priority Fulfillment Services, Inc. Project) (the "Bonds"), to be issued on the date of the acceptance hereof pursuant to a Trust Indenture dated as of November 1, 2004 (the "Indenture") between the Mississippi Business Finance Corporation (the "Issuer") and U.S. Bank National Association, as Trustee (the "Trustee"). The proceeds of the Bonds are to be loaned to the Obligor pursuant to a Loan Agreement dated as of November 1, 2004 (the "Loan Agreement") between the Issuer and the Obligor. The payment when due of the principal and interest on (and purchase price of) the Bonds will be supported, to the extent provided therein, by a Letter of Credit issued by Comerica Bank, Detroit, Michigan (the "Bank") pursuant to a Reimbursement Agreement dated as of November 1, 2004 (the "Reimbursement Agreement") between the Obligor and the Bank. The Bonds will bear interest at the initial rate of \_\_\_\_% and are more fully described in the Preliminary Private Placement Memorandum dated December 15, 2004 (the "Preliminary Private Placement Memorandum") and the Private Placement Memorandum dated December 22, 2004 (the "Private Placement Memorandum") prepared in connection with the placement of the Bonds.

**SECTION 1. REPRESENTATIONS, WARRANTIES AND COVENANTS OF THE ISSUER.** By the Issuer's acceptance hereof, the Issuer hereby represents and warrants to, and agrees with, the Placement Agent that as of the date of acceptance of this Agreement:

(a) The Issuer is duly authorized under the constitution and laws of the State of Mississippi to issue the Bonds and to execute, deliver and perform its obligations hereunder

and under the Loan Agreement, the Indenture and the Bonds, to pledge the Security described in the Indenture and pledged thereby in the manner and to the extent therein set forth; all actions required of the Issuer for the issuance of the Bonds and the execution and delivery of, and the performance of its obligations under, this Agreement and under the Loan Agreement, the Indenture and the Bonds have been duly and effectively taken; this Agreement, the Loan Agreement and the Indenture have been duly executed, issued and delivered by the Issuer and, assuming the due authorization and execution thereof by the other parties thereto, are valid, binding and enforceable agreements of the Issuer, except as the enforceability thereof may be limited by bankruptcy, insolvency or similar laws affecting the enforcement of creditors' rights generally and general principles of equity; and the Bonds have been duly authorized, executed, issued and delivered and constitute valid and binding limited obligations of the Issuer, enforceable in accordance with their respective terms, except as the enforceability thereof may be limited by bankruptcy, insolvency or similar laws affecting the enforcement of creditors' rights generally and general principles of equity.

(b) There is no action, suit, proceeding, inquiry or investigation at law or in equity or before or by any court, public board or body or other governmental authority pending, with respect to which the Issuer has received service of process, or, to the knowledge of the Issuer, is threatened against or affecting it wherein an unfavorable decision, ruling or finding could adversely affect the transactions contemplated by this Agreement, or which in any way raises any question concerning the legality, validity or enforceability of this Agreement, the Bonds, the Indenture or the Loan Agreement, nor to the best knowledge and belief of the Issuer is there any basis therefor.

(c) The execution, delivery and performance by the Issuer of this Agreement, the Loan Agreement, the Indenture and the Bonds do not and will not violate any order, injunction, ruling or decree by which the Issuer is bound, and do not and will not constitute a breach of or a default under any agreement, indenture, mortgage, lease, note or other obligation, instrument or arrangement to which the Issuer is a party or by which the Issuer or any of its property is bound, or contravene or constitute a violation of any law, rule or regulation to which the Issuer or any of its property is subject, and no approval or other action by, or filing or registration with, any governmental authority or agency is required in connection therewith which has not been previously obtained or accomplished (except that the Issuer makes no representation as to compliance with state securities or "Blue Sky" laws or the securities laws of the United States or as to any permits, governmental permissions, including environmental clearances, rights and licenses, as may be necessary for the construction and operation of the Project (as defined in the Indenture), as to which no representation or warranty or covenant is made).

(d) The information contained under the caption "The Issuer" in each of the Preliminary Private Placement Memorandum and the Private Placement Memorandum is true and correct and does not contain any untrue statement of a material fact and does not omit to state a material fact necessary in order to make the statements made therein, in light of the circumstances under which they were made, not misleading.

(e) Each of the representations and warranties of the Issuer contained in the Loan Agreement and in the Indenture are true and correct on and as of the date hereof and are hereby made to the Placement Agent on and as of the date hereof as if set forth herein at length.

(f) The Issuer will not knowingly take any action or fail to take any action it alone could take, which action or omission might in any way result in the loss of the exclusion of interest on the Bonds from gross income for federal income tax purposes.

(g) Any certificate signed by any member or authorized officer of the Issuer and delivered to the Placement Agent shall be deemed a representation and warranty by the Issuer to the Placement Agent as to the statements made therein.

(h) The Issuer shall cooperate with the Placement Agent in any endeavor to qualify the Bonds for offering and sale under the securities or "Blue Sky" laws of such jurisdictions of the United States as the Placement Agent may request; and the Issuer will furnish such information, execute such instruments and take such other action in cooperation with the Placement Agent as the Placement Agent may reasonably request in connection therewith; provided, however, that the Issuer shall not be required to register as a dealer or a broker in any such state or jurisdiction or make any additional representations or warranties in connection with the sale of securities, or to subject itself to service of process in any state or jurisdiction other than the State of Mississippi. The Issuer consents to the use of the Preliminary Private Placement Memorandum and the Private Placement Memorandum by the Placement Agent in obtaining such qualification.

**SECTION 2. REPRESENTATIONS, WARRANTIES AND COVENANTS OF THE OBLIGOR.** By its acceptance hereof, the Obligor represents and warrants to, and agrees with, the Placement Agent and the Issuer that:

(a) The Obligor has taken all necessary action to authorize, execute and deliver this Agreement, the Loan Agreement and the other documents and agreements (including, without limitation, the Reimbursement Agreement) executed and delivered in connection with the issuance of the Bonds and the other transactions contemplated hereby (each a "Related Document" and, collectively, the "Related Documents") to which it is a party, and this Agreement, the Loan Agreement and the Related Documents to which it is a party have been duly executed and delivered by the Obligor and constitute the legal, valid and binding obligations of the Obligor, enforceable in accordance with their respective terms except as the enforceability thereof may be limited by bankruptcy, insolvency or similar laws affecting the enforcement of creditors' rights generally and general principles of equity.

(b) There is no action, suit, proceeding, inquiry or investigation at law or in equity, or before or by any court, public board or body or other governmental authority, pending or, to the best knowledge and information of the Obligor, threatened against or affecting the Obligor, wherein an unfavorable decision, ruling or finding could materially adversely affect the business or financial condition of the Obligor or could adversely affect the transactions contemplated by this Agreement or the Private Placement Memorandum, or which in any manner raises any question concerning the legality, validity or enforceability of this Agreement, the

Bonds, the Indenture, the Loan Agreement or any Related Document to which the Obligor is a party, nor to the best knowledge and belief of the Obligor is there any basis therefor.

(c) The execution, delivery and performance by the Obligor of this Agreement, the Loan Agreement and the Related Documents to which it is a party do not and will not materially violate the Charter or By-laws of the Obligor, or any order, injunction, ruling or decree by which the Obligor is bound, and do not and will not constitute a material breach of or a default under any agreement, indenture, mortgage, lease, note or other obligation, instrument or arrangement to which the Obligor is a party or by which the Obligor or any of its property is bound, or to the Obligor's best knowledge contravene or constitute a material violation of, any law, rule or regulation to which the Obligor or any of its property is subject, and to the Obligor's best knowledge no approval or other action by, or filing or registration with, any governmental authority or agency is required in connection therewith which has not been previously obtained or accomplished, provided that, for this purpose, the terms "materially" and "material" mean that such event or circumstance will not adversely affect the (1) Obligor's power and authority to execute this Agreement, the Loan Agreement and the Related Documents, (2) the enforceability against the Obligor of such documents or (3) the Obligor's ability to repay the Bonds.

(d) The descriptions and information contained in the Preliminary Private Placement Memorandum as of its date and the Private Placement Memorandum as of its date under the captions "Introductory Statement," "The Obligor and the Use of Proceeds," "The Bonds" (other than the information under the sub-heading "Book-Entry System"), "Sources of Payment and Security," "The Letter of Credit," "The Reimbursement Agreement," "The Loan Agreement," "The Pledge and Security Agreement," and "The Trust Indenture" (such descriptions and information are referred to herein as the "Obligor's Portion of the Preliminary Private Placement Memorandum" and the "Obligor's Portion of the Private Placement Memorandum," respectively) are true and correct in all material respects and do not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made therein, in light of the circumstances under which they were made, not misleading.

(e) Each of the Obligor's representations and warranties contained in the Loan Agreement are true and correct on and as of the date hereof and are hereby made to the Placement Agent on and as of the date hereof as if set forth herein at length.

(f) Any certificate signed by any officer of the Obligor and delivered to the Placement Agent shall be deemed a representation and warranty by the Obligor to the Placement Agent as to the statements made therein.

(g) The Obligor shall cooperate with the Placement Agent in any endeavor to qualify the Bonds for offering and sale under the securities or "Blue Sky" laws of such jurisdictions of the United States as the Placement Agent may request; and the Obligor will furnish such information, execute such instruments and take such other action in cooperation with the Placement Agent as the Placement Agent may reasonably request in connection therewith; provided, however, that the Obligor shall not be required to register as a dealer or a broker in any such state or jurisdiction or make any additional representations or warranties in

connection with the sale of securities, or to subject itself to service of process in any state or jurisdiction in which it is not already so subject. The Obligor consents to the use of the Preliminary Private Placement Memorandum and the Private Placement Memorandum by the Placement Agent in obtaining such qualification.

**SECTION 3. APPROVAL OF PRIVATE PLACEMENT MEMORANDUM.** The Issuer and the Obligor ratify, and the Issuer and the Obligor consent to the use by the Placement Agent of, the Preliminary Private Placement Memorandum in connection with the offering of the Bonds prior to the date hereof. On or before the date of issuance of the Bonds, the Issuer (at the Obligor's expense) shall deliver to the Placement Agent such reasonable number of copies of the Private Placement Memorandum as the Placement Agent shall request. The Issuer and the Obligor authorize and approve the Private Placement Memorandum and consent to the use by the Placement Agent of the Private Placement Memorandum in connection with the offering of the Bonds.

**SECTION 4. PLACEMENT OF THE BONDS.** The Placement Agent shall use its best efforts to solicit, at the rate of interest established by the Remarketing Agent pursuant to Section 110(b) of the Indenture, purchases of the Bonds and the beneficial interests in the Bonds by sophisticated investors which customarily purchase corporate securities in large denominations at a price of par in connection with the initial sale of the Bonds and the beneficial interests in the Bonds by the Issuer. The Purchasers of the Bonds are to purchase the Bonds at a price equal to 100% of the principal amount thereof and to pay the purchase price thereof on the date of issuance of the Bonds (the "Closing"). Each of the Purchasers is to deposit the purchase price of their respective Bonds with the Placement Agent for transfer by the Placement Agent to the Trustee on the date of issuance of the Bonds. The Issuer and the Obligor approve the placement of the Bonds with the Purchasers on the terms referred to herein. It is understood that the purchase of the Bonds by the Purchasers is subject to the performance by the Obligor and the Issuer of their obligations to be performed hereunder at and prior to the Closing, to the accuracy in all material respects of the representations and warranties of the Obligor and the Issuer herein as of the time of the Closing, and to the following conditions, including the delivery by the Obligor and the Issuer of such documents and opinions as are enumerated herein in form and substance reasonably satisfactory to the Placement Agent:

(a) At the time of the Closing, (i) the Indenture, the Loan Agreement and the Letter of Credit shall be in full force and effect in the form heretofore approved by the Obligor, the Issuer, the Trustee and the Placement Agent and none of the foregoing documents shall have been amended, modified or supplemented from the forms thereof as of the date hereof, except as may have been approved by the Placement Agent, the Closing in all events, however, to be deemed such approval, (ii) the proceeds of the sale of the Bonds shall be deposited and applied as described in the Loan Agreement and the Indenture and  
(iii) the Obligor and the Issuer shall have duly adopted and there shall be in full force and effect such resolutions as are necessary in connection with the transactions contemplated herein and in the Private Placement Memorandum.

(b) At or prior to the Closing, the Indenture shall have been executed and

delivered by the Issuer and the Trustee, the Loan Agreement shall have been executed and delivered by the Issuer and the Obligor, the Reimbursement Agreement shall have been executed and delivered by the Obligor and the Bank, and the Letter of Credit shall have been executed and delivered by the Bank.

(c) At the Closing, the Issuer shall deliver the Bonds duly executed.

(d) At or prior to the Closing, the Placement Agent shall receive the following documents in such number of counterparts as shall be mutually agreeable to the Placement Agent, the Issuer and the Obligor:

- (1) The opinion of Wolff & Samson, counsel to the Obligor, dated the date of Closing;
- (2) The approving opinion of Watkins Ludlam Winter & Stennis, P.A., Bond Counsel, dated the date of Closing;
- (3) The supplemental opinion of Watkins Ludlam Winter & Stennis, P.A., Bond Counsel, dated the date of Closing;
- (4) The preference opinion of Watkins Ludlam Winter & Stennis, P.A., dated the date of Closing addressed to the Placement Agent;
- (5) The enforceability opinion of Bodman LLP, counsel to the Bank, dated the date of Closing, addressed to the Placement Agent, the Issuer and the Trustee;
- (6) A certificate dated the date of Closing and signed by an authorized official of the Obligor acceptable to the Placement Agent to the effect that (A) each of the representations and warranties of the Obligor set forth herein and in the Loan Agreement and the Reimbursement Agreement shall be accurate as if made on and as of the date of Closing, (B) all of the conditions and agreements required in this Agreement and the Reimbursement Agreement to be satisfied or performed by the Obligor at or prior to the date of Closing shall have been satisfied or performed in the manner and with the effect contemplated herein, and (C) as of the date of Closing, no Event of Default on the part of the Obligor under the Loan Agreement or the Reimbursement Agreement has occurred and is continuing and no event has occurred and is continuing which, with the lapse of time or the giving of notice, or both, would constitute such an Event of Default;
- (7) A certificate dated the date of Closing and signed by a member or an authorized officer of the Issuer to the effect that (A) each of the representations and warranties of the Issuer set forth herein and in the Indenture and the Loan Agreement shall be accurate as if made on and as of the date of Closing, (B) all of the conditions and agreements required in this Agreement to be satisfied or performed by the Issuer at or prior to the date of Closing shall have been satisfied or performed in the manner and with the effect contemplated herein and (C) as of

the date of Closing, no Event of Default on the part of the Issuer under the Indenture or the Loan Agreement has occurred and is continuing and no event has occurred and is continuing which, with the lapse of time or the giving of notice, or both, would constitute such an Event of Default;

(8) A certificate dated the date of Closing and signed by an authorized official of the Bank as to the due execution and delivery of the Letter of Credit by the Bank and as to the accuracy of the information regarding the Bank contained in the Private Placement Memorandum;

(9) A certificate of a duly authorized officer of the Trustee as to the due execution of the Indenture by the Trustee and the due authentication and delivery of the Bonds by the Trustee;

(10) A specimen Bond;

(11) A specimen Letter of Credit; and

(12) Such additional legal opinions, certificates, proceedings, instruments and other documents as the Placement Agent may reasonably request in connection with the transactions contemplated by this Agreement.

**SECTION 5. PAYMENT TO THE ISSUER AND DELIVERY OF BONDS.** The Placement Agent agrees that it will, on the date of issuance of the Bonds, transfer to the Trustee, for the account of the Issuer, the purchase price of the Bonds, but only to the extent that the Purchasers have deposited the purchase price of their respective Bonds with the Placement Agent. If any Purchaser does not deposit the purchase price of its Bonds or otherwise refuses to purchase its Bonds, the Placement Agent will use its best efforts to arrange for a substitute purchaser for such Bonds.

The Bonds will be delivered as fully registered bonds in such authorized denominations and registered in such names and in such amounts as the Placement Agent may have requested not less than one business day prior to the date of issuance of the Bonds. The Bonds will be made available for checking and packaging by the Placement Agent not less than one business day prior to the date of issuance of the Bonds, at such place as the Obligor, the Issuer, the Placement Agent and the Trustee shall agree. It is anticipated that a CUSIP identification number will be typed or printed on the Bonds. The Issuer, the Obligor and the Placement Agent will cooperate to obtain the CUSIP number.

**SECTION 6. LIMITATION.** Nothing contained in this Placement Agreement shall obligate the Placement Agent to purchase any Bond in the event that any Purchaser fails to pay the purchase price for such Bond on the date of issuance of the Bonds.



## SECTION 7. FEES AND EXPENSES.

(a) The Placement Agent shall be entitled to a fee in the amount of \$43,750 for its services hereunder, which fee shall be payable by the Obligor on the date of sale and delivery of the Bonds. The parties hereto recognize and agree that the Issuer shall have no liability with respect to payment of the foregoing fee.

(b) The Obligor shall pay all other costs and expenses incurred in connection with the issuance and placement of the Bonds and the preparation, execution, delivery and filing of this Agreement, the Private Placement Memorandum, the Indenture, the Loan Agreement, the Bonds, the Reimbursement Agreement and any other Related Document, and any other documents which may be delivered in connection herewith or therewith, including the fees and disbursements of Bond Counsel, the fees and disbursements of counsel for the Bank, the fees and disbursements of counsel for the Placement Agent, the fees and expenses of the Trustee and its counsel, the fees and expenses of the Issuer, the cost of printing the Bonds, letter of credit fees, the fees and expenses of accountants and any other experts retained by the Obligor or the Placement Agent in connection with the issuance and placement of the Bonds.

## SECTION 8. INDEMNIFICATION AND CONTRIBUTION.

(a) The Obligor will indemnify and hold harmless the Placement Agent, its officers and employees, and each person who controls the Placement Agent within the meaning of Section 15 of the Securities Act of 1933, as amended, or Section 20(a) of the Securities Exchange Act of 1934, as amended, (each an "Indemnified Party" and, collectively, the "Indemnified Parties"), against any losses, claims, damages or liabilities, joint or several, to which any Indemnified Party may become subject, insofar as such losses, claims, damages or liabilities, or actions in respect thereof, (i) arise out of or are based upon an untrue statement or alleged untrue statement of a material fact contained in the Obligor's Portion of the Preliminary Private Placement Memorandum or the Obligor's Portion of the Private Placement Memorandum or any amendment or supplement thereto or (ii) arise out of or are based upon the omission or alleged omission to state in the Obligor's Portion of the Preliminary Private Placement Memorandum or the Obligor's Portion of the Private Placement Memorandum or any amendment or supplement thereto a material fact known to the Obligor necessary in order to make the statements made therein, in the light of the circumstances under which they were made, not misleading. The foregoing indemnity shall include reimbursement for any legal or other expenses reasonably incurred by any Indemnified Party in connection with investigating or defending any such action or claim.

The Placement Agent will, promptly after receiving notice of the commencement of any action against the Placement Agent in respect of which indemnification may be sought against the Obligor, notify the Obligor in writing of the commencement of the action. Failure of the Placement Agent to give such notice will reduce the liability of the Obligor under this indemnity agreement by the amount of the damages attributable to the failure to give the notice; but the failure will not relieve the Obligor from any liability it may have to the Placement Agent otherwise than under the indemnity agreement in this Section. If any such action is brought against the Placement Agent and the Placement Agent notifies the Obligor of its commencement,

the Obligor may, or if so requested by the Placement Agent shall, participate in its or assume its defense, with counsel reasonably satisfactory to the Placement Agent, and after being so requested to assume such defense or if the Placement Agent gives notice to the Obligor that it elects to assume such defense, the Obligor (subject to the next succeeding sentence) will not be liable to the Placement Agent under this Section for any legal or other expenses subsequently incurred by the Placement Agent other than reasonable costs of investigation incurred at the request, or with the consent, of the Obligor. If the Obligor does not employ counsel to have charge of the defense or if the Placement Agent reasonably concludes that there may be defenses available to it which are different from or in addition to those available to the Obligor (in which case the Obligor will not have the right to direct the defense of such action on behalf of the Placement Agent), reasonable legal and other expenses incurred by the Placement Agent will be paid by the Obligor. Any obligation under this Section of the Obligor to reimburse the Placement Agent for expenses includes the obligation to make advances to the Placement Agent to cover such expenses in reasonable amounts and at reasonable periodic intervals not more often than monthly as requested by the Placement Agent.

(b) If the indemnification provided for in subsection (a) of this

Section is unavailable to the Placement Agent (or any controlling person thereof) in respect to any losses, claims, damages or liabilities referred to therein, then the Obligor shall, in lieu of indemnifying the Placement Agent, contribute to the amount paid or payable by the Placement Agent as a result of such losses, claims, damages or liabilities in such proportion as is appropriate to reflect the relative benefits received by the Obligor and the Placement Agent, respectively, from the placement of the Bonds. If, however, the allocation provided by the immediately preceding sentence is not permitted by applicable law, then the Obligor shall contribute to such amount paid or payable by the Placement Agent in such proportion as is appropriate to reflect not only such relative benefits but also the relative fault of the Obligor and the Placement Agent, respectively, in connection with the statements or omission which resulted in such losses, claims, damages or liabilities, as well as any other relevant equitable considerations. The relative benefit received by the Obligor or the Placement Agent, respectively, shall be deemed to be in the same proportion as the total proceeds from the placement of the Bonds (before deducting costs and expenses other than placement fees and expenses), on the one hand, bear to the total placement fees and expenses received by the Placement Agent, on the other hand. The relative fault shall be determined by reference to, among other things, whether the untrue or alleged untrue statement of a material fact or the omission or alleged omission to state a material fact related to information supplied by the Obligor or the Placement Agent and the parties' relative intent, knowledge, access to information and opportunity to correct or prevent such statement or omission. The Obligor and the Placement Agent, respectively, agree that it would not be just and equitable if contribution pursuant to this Section were determined by pro rata allocation or by any other method of allocation which does not take account of the equitable considerations referred to above in this Section. The amount paid or payable by the Placement Agent as a result of the losses, claims, damages or liabilities referred to above in this Section shall be deemed to include any legal or other expenses reasonably incurred by the Placement Agent in connection with investigating or defending any such action or claim. Notwithstanding the provisions of this subsection (b), the Placement Agent shall not be required to contribute any amount in excess of the placement fee paid to the Placement Agent under Section 7(a) hereof.

The obligations of the Obligor under this Section 8 shall survive the issuance and the maturity of the Bonds and the termination of this Agreement.

**SECTION 9. RESPONSIBILITIES OF PLACEMENT AGENT.** The Placement Agent agrees that it will not solicit offers to purchase any Bonds or beneficial interests in the Bonds except: (i) in jurisdictions (A) where the Bonds or the beneficial interests in the Bonds are qualified for offering and sale, and the Placement Agent is qualified to offer and sell the Bonds or the beneficial interests in the Bonds on behalf of the Issuer, or (B) where the Bonds, the beneficial interests in the Bonds and the Placement Agent are exempt from registration; and (ii) where such solicitation would not violate or give rise to a violation of the securities laws of the United States of America or of a jurisdiction in which offers to purchase the Bonds or the beneficial interests in the Bonds are solicited.

**SECTION 10. GOVERNING LAW.** This Agreement shall be governed by and construed in accordance with the laws of the State of Mississippi.

**SECTION 11. COUNTERPARTS.** This Agreement may be signed in any number of counterparts, each of which shall be an original, and by the parties hereto on separate counterparts, with the same effect as if the signatures thereto and hereto were upon the same instrument.

**SECTION 12. BINDING EFFECT.** This Agreement shall be binding upon, and inure to the benefit of, the parties hereto and their respective successors and assigns, except that no party hereto may assign any of its rights or obligations hereunder without the consent of the other parties.

**SECTION 13. SURVIVAL OF ISSUER'S AND OBLIGOR'S REPRESENTATIONS AND OBLIGATIONS.** The respective agreements, representations (which are made only as of the date this Agreement is accepted) and warranties of the Issuer and the Obligor and their respective officials or officers set forth in, or made pursuant to, this Agreement will remain in full force and effect, regardless of any investigation, or statement as to the results thereof, made by or on behalf of the Placement Agent, the Issuer, the Obligor or any of their respective officials, officers or directors or agents or any controlling person, referred to in the first paragraph of Section 8, and will survive delivery of and payment for the Bonds, the maturity of the Bonds and any termination of this Agreement.

**SECTION 14. FAILURE OF PURCHASE TO OCCUR.** If for any reason the purchase of the Bonds by any Purchaser is not consummated, the Obligor shall remain responsible for the expenses to be paid or reimbursed by it pursuant to Section 7(b), and the obligations of the Obligor pursuant to Section 8 shall remain in effect.

**[THE BALANCE OF THIS PAGE INTENTIONALLY LEFT BLANK.  
SIGNATURE PAGE TO FOLLOW.]**

**PLACEMENT AGREEMENT**  
**Signature Page**

IN WITNESS WHEREOF, the parties have caused this Agreement to be executed and delivered by their duly authorized officers as of the date first above written.

**COMERICA SECURITIES**

By: \_\_\_\_\_  
Michael J. Wilk  
Its: Managing Director

Accepted this 29th day of December, 2004 by

**MISSISSIPPI BUSINESS FINANCE  
CORPORATION**

By: \_\_\_\_\_  
Bill Barry  
Its: Executive Director

**Attest:**

By: \_\_\_\_\_  
Vernon Smith  
Its: Secretary

**PRIORITY FULFILLMENT SERVICES,  
INC.**

By: \_\_\_\_\_  
Thomas J. Madden  
Its: Chief Financial Officer

**EXHIBIT 10.56**

**REIMBURSEMENT AGREEMENT**

**BETWEEN**

**PRIORITY FULFILLMENT SERVICES, INC.**

**AND**

**COMERICA BANK**

**EXECUTION COPY**

## EXHIBIT 10.56

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## **REIMBURSEMENT AGREEMENT**

REIMBURSEMENT AGREEMENT (the "Agreement") dated as of November 1, 2004 (the "Execution Date") by and between PRIORITY FULFILLMENT SERVICES, INC., a Delaware corporation, whose address is 500 N. Central Expressway, 5th Floor, Plano, Texas 75074 (the "Obligor") and COMERICA BANK, a Michigan banking corporation, with an office located at 800 E. Campbell Road, Suite 254, Richardson, Texas 75081 (the "Bank").

### **WITNESSETH:**

WHEREAS, the Obligor has requested the Mississippi Business Finance Corporation (the "Issuer") to finance the cost of acquiring equipment and machinery (and related assets) to be used at a distribution facility located at 8474 Marketplace, Southaven, Mississippi (the financing of the machinery and equipment collectively referred to herein as the "Project") by the issuance and sale, pursuant to a Trust Indenture dated as of November 1, 2004 (the "Indenture"), naming U.S. Bank National Association, as trustee (the "Trustee"), of \$5,000,000 principal amount of the Issuer's Variable Rate Demand Limited Obligation Revenue Bonds (Priority Fulfillment Services, Inc. Project), Series 2004 (the "Bonds") to the purchaser or purchasers (the "Bond Purchasers"); and

WHEREAS, in order to induce the Bond Purchasers to purchase the Bonds, the Obligor has requested that the Bank issue an irrevocable letter of credit (such letter of credit and any successor letter of credit as described in Section 2 of this Agreement being herein called the "Letter of Credit") in an amount not to exceed \$5,061,643.84 (such amount being herein called the "Letter of Credit Amount") to secure payment of the principal and purchase price of, and interest on, the Bonds;

NOW, THEREFORE, in consideration of the premises, the Obligor and the Bank hereby agree as follows:

#### **SECTION 1. Reimbursement and Other Payments.**

(a) The Obligor hereby agrees with the Bank as follows: (i) to pay the Bank, following payment by the Bank of any drawing presented under a Letter of Credit (other than a Purchase Drawing (as defined in the Letter of Credit)), and on the same day on which such drawing is so paid, a sum (and interest on such sum as provided in clause (ii) below) equal to the amount so paid under the Letter of Credit; (ii) to pay the Bank, interest on any and all amounts remaining unpaid by the Obligor hereunder, at any time from the date any such amount becomes payable until payment in full, payable on demand, at a fluctuating interest rate per annum (computed on the basis of a 360 day year for the actual number of days elapsed) as shall be in effect from time to time, which rate per annum shall be equal to three percent (3%) above its prime rate established by the Bank from time to time, which prime rate may not necessarily be the Bank's lowest rate for loans ("Prime Rate"), provided that such fluctuating interest rate shall in no event be higher than the maximum rate permitted by law and, in addition, upon demand by the Bank any and all reasonable expenses including but not limited to legal expenses incurred by the Bank in enforcing any rights under this Agreement.

(b) The Obligor hereby agrees to pay to the Bank, following payment by the Bank of any Purchase Drawing presented under the Letter of Credit, interest on all amounts owed the Bank as the result of the Bank honoring the Drawing, payable monthly, at a fluctuating interest rate per annum (computed on the basis of a year of 360 days) equal to one percent (1%) above the Bank's Prime Rate. The Bank shall notify the Obligor in writing of the amounts due pursuant to this Subsection 1(b). The amount of each Purchase Drawing shall be due and payable upon the earlier of (A) the expiration or earlier termination date of the Letter of Credit, (B) upon the occurrence of an Event of Default, (C) immediately from the proceeds of a remarketing of the Bonds to the extent of such remarketing proceeds; or (D) sixty (60) days after the date of such Purchase Drawing.

(c) In addition, the Obligor hereby agrees to pay to the Bank a commission with respect to the Letter of Credit, computed (on the basis of a year of 360 days for the actual number of days elapsed) at the rate of three quarters of one percent (3/4%) per annum on the Letter of Credit Amount (or, in the event, and effective the first date on which an annual payment of the Letter of Credit commission is due following the date of any reduction in the maximum amount available under the Letter of Credit in accordance with the terms thereof, on such smaller amount to which the maximum amount available under the Letter of Credit may have been so reduced from time to time) from and including the date of issuance of the Letter of Credit to but excluding the last day a drawing is available under the Letter of Credit (the "Expiration Date"), payable annually in advance on the first day of December of each year until the Expiration Date; provided, that the first installment shall be payable on the date of issuance of the Letter of Credit for the period from and including such date of issuance until November 30, 2005. If the Expiration Date occurs on a day prior to the date to which a commission has been prepaid under this Section 1(b), the Bank agrees to repay, promptly after the Expiration Date, such portion of such commission as is allocable to the period from and including the Expiration Date until the day to which such commission has been prepaid; provided, that the Bank shall not be obligated to repay any portion of such commission if at the close of the Bank's business on the Expiration Date an Event of Default shall have occurred and is then continuing.

(d) If any change in any law or regulation or in the interpretation or implementation thereof by any court or administrative or governmental authority charged with the administration thereof (including, without limitation, a change in a requirement that affects the manner in which the Bank allocates capital resources to its commitments, including its obligations hereunder and under the Letter of Credit) shall either (i) impose, modify or deem applicable any reserve, special deposit, limitation or similar requirement against letters of credit issued by, or assets held by, or deposits in or for the account of, the Bank or (ii) impose upon, modify, require, make or deem applicable to the Bank any increased capital requirement or similar requirement (including, without limitation, a new requirement that affects the manner in which the Bank allocates capital resources to its commitments including its obligations hereunder or under the Letter of Credit) or (iii) impose on the Bank any other condition regarding this Agreement or the Letter of Credit, and the result of any event referred to in clause (i), (ii) or (iii) above shall be an increase in the cost to the Bank of issuing or maintaining the Letter of Credit or reduce the rate of return on capital, as a consequence of the issuing or maintaining the Letter of Credit or performing the Bank's obligations hereunder, to a level below that which the Bank would have achieved but for such events; (which increase in cost or decreased benefit shall be determined by the Bank's reasonable allocation of the aggregate of such cost increases or reduced benefits resulting from



such events), then, upon demand by the Bank, the Obligor, shall immediately pay to the Bank, from time to time as specified by the Bank, additional amounts which shall be sufficient to compensate the Bank for such increased cost or decreased benefit, together with interest on each such amount commencing the date such compensation is demanded until payment in full thereof at the rate provided in subsection (a)(ii) above. A certificate as to such increased cost or decreased benefit incurred by the Bank as a result of any event mentioned in clause (i), (ii) or (iii) above, submitted by the Bank to the Obligor, shall be rebuttably presumed correct as to the amount thereof absent fraud or demonstrable mistake in calculation.

(e) In addition, in the event that a successor Trustee is appointed pursuant to the Indenture, the Obligor agrees to pay the Bank a commission equal to \$1,500 for transferring the Letter of Credit to the successor Trustee, plus any out-of-pocket expenses incurred by the Bank in connection with such transfer. Both such commission and such expenses shall be paid at the time of transfer of the Letter of Credit.

(f) In addition, the Obligor agrees to pay the Bank a Letter of Credit draw processing fee equal to \$250, plus wiring and mailing expenses for each drawing under the Letter of Credit submitted by the Trustee to the Bank (if an interest drawing and a principal drawing are submitted at the same time, they shall be treated as one drawing for purposes of determining the draw processing fee), said fee to be due and payable on the date a drawing is submitted by the Trustee to the Bank.

(g) All payments by the Obligor to the Bank hereunder shall be made in lawful money of the United States and in immediately available funds at the Bank's office at 500 Woodward Avenue, Detroit, Michigan 48226, or such other office of the Bank as may be designated from time to time by written notice to the Obligor by the Bank. All such payments will be charged when due to Obligor's account no. 1892024777 maintained with Bank (or any other deposit or other accounts of Obligor with Bank); provided, however, this authorization shall not affect Obligor's obligation to pay, when due, any indebtedness hereunder whether or not account balances are sufficient to pay amounts due.

SECTION 2. Issuance of Letter of Credit. On or before December 29, 2004, upon written notice from the Obligor to the Bank and subject to the satisfaction of the conditions precedent specified in Section 3 below, the Bank will issue the Letter of Credit in substantially the form of Exhibit "A" hereto, in favor of the Trustee and expiring no later than December 16, 2006. The Obligor hereby requests that the Bank issue the Letter of Credit in the form attached as Exhibit "A".

SECTION 3. Conditions Precedent to the Issuance of the Letter of Credit. The obligation of the Bank to issue the Letter of Credit is subject to the satisfaction of the following conditions precedent:

(a) On or before the date of issuance of the Letter of Credit, the Obligor shall have paid to the Bank the commission payable on such date of issuance under Section 1(c) above.

- (b) On or before the date of issuance of the Letter of Credit, the Bank shall have received the following, each dated contemporaneous with the date of issuance of the Letter of Credit and in form and substance satisfactory to the Bank:
- (i) Certified copies of resolutions of the Board of Directors of the Obligor approving this Agreement, the form and content of the Letter of Credit and the other matters and documents contemplated hereby.
  - (ii) A Certificate of the Secretary or an Assistant Secretary of the Obligor, certifying the names and true signatures and incumbency of the officers of the Obligor, authorized to sign this Agreement, and the other documents to be delivered by it hereunder.
  - (iii) Certified copies of the Articles of Incorporation of the Obligor and certificates of good standing for the Obligor from each jurisdiction in which its conduct or activities require it to be licensed to do business.
  - (iv) A full set of the Obligor's Bylaws duly certified by the Secretary or an Assistant Secretary of the Obligor.
  - (v) Favorable opinion of Wolff and Samson counsel for the Obligor and the Guarantor (as defined herein), in form and substance satisfactory to the Bank.
  - (vi) A favorable opinion of Watkins, Ludden, Winter & Stennis, P.A., as Bond Counsel, in form and substance satisfactory to the Bank.
  - (vii) A favorable opinion of Bodman LLP, as counsel for the Bank, in form and substance satisfactory to the Bank.
  - (viii) An executed copy of the Indenture (or a copy thereof certified as to authenticity by the Trustee)
  - (ix) An executed copy of that certain Loan Agreement dated as of the Execution Date between the Issuer and the Obligor (the "Loan Agreement") (or a copy thereof certified as to authenticity by Counsel for or an agent of the Issuer).
  - (x) Counterpart originals of the guarantees, mortgages, security agreements, subordination agreements and other documents constituting the Collateral Documents (as defined in Section 9 of this Agreement) together with evidence of such recordings, filings of financing statements or of other actions necessary or desirable to establish the priority of lien in the Security (as defined in Section 9 of this Agreement) as the Bank may require.
  - (xi) A copy of the Private Placement Memorandum (together with the documents incorporated therein by reference, herein called the "Private Placement Memorandum") of the Issuer relating to the Bonds.

(xii) An executed original of that certain Pledge and Security Agreement dated as of the Execution Date between the Obligor, the Bank and the Trustee.

(xiii) A redemption notice to the Trustee duly executed by Obligor with respect to the redemptions required under Section 6(d) of this Agreement.

(xiv) Such other documents, instruments, approvals (and, if requested by the Bank, certified duplicates of executed copies thereof) or opinions as the Bank may reasonably request.

(c) The following statements shall be true and correct on and as of the date of issuance of the Letter of Credit, and the Bank shall have received a certificate signed by a duly authorized officer of the Obligor, dated the date of such issuance, stating that:

(i) the representations and warranties contained in Section 5 of this Agreement are correct on and as of the date of such issuance as though made on and as of such date; and

(ii) no event has occurred which constitutes an Event of Default or which would constitute an Event of Default but for the requirement that notice be given or time elapse or both, nor will the issuance of the Letter of Credit give rise to the occurrence of an Event of Default.

(d) On or before the day of the issuance of the Letter of Credit:

(i) the Issuer and the Trustee shall have duly authorized and executed the Indenture and the Indenture shall continue to be in full force and effect;

(ii) the Obligor and the Issuer shall have duly authorized and executed the Loan Agreement and the Loan Agreement shall continue to be in full force and effect;

(iii) the Obligor shall have duly authorized and executed the Collateral Documents and the Collateral Documents shall continue to be in full force and effect;

(iv) the Bonds, the Indenture, the Loan Agreement, the Collateral Documents, the Pledge and Security Agreement and any other agreement or instrument relating to any of the foregoing (the "Operative Documents") shall be in form and substance satisfactory to the Bank.

**SECTION 4. Obligations Absolute.** The payment obligations of the Obligor under this Agreement shall be absolute, unconditional and irrevocable, and shall be paid strictly in accordance with the terms of this Agreement, under all circumstances whatsoever, including, without limitation, the following circumstances, either alleged or established:

(a) any lack of validity or enforceability of the Operative Documents;

(b) any amendment or waiver of or any consent to departure from or in connection with the Operative Documents, including any substitution, exchange or release of collateral with respect to any of the Operative Documents;

(c) the existence of any claim, set-off, defense or other right which the Obligor may have at any time against the Trustee, any beneficiary or any transferee of the Letter of Credit (or any persons or entities for whom the Trustee, any such beneficiary or any such transferee may be acting), the Bank or any other person or entity, whether in connection with this Agreement, the Operative Documents, the transactions contemplated herein or therein or any unrelated transaction;

(d) any statement or any other document presented under the Letter of Credit proving to be forged, fraudulent, invalid or insufficient in any respect or any statement therein being untrue or inaccurate in any respect whatsoever;

(e) payment in good faith by the Bank under the Letter of Credit against presentation of a drawing or certificate which does not comply with the terms of the Letter of Credit;

(f) any failure, omission, delay or lack on the part of the Bank or any party to any of the Operative Documents to enforce, assert or exercise any right, power or remedy conferred upon the Bank or any such party under this Agreement or any of the Operative Documents, or any other acts or omissions on the part of the Bank or any such party;

(g) the voluntary or involuntary liquidation, dissolution, sale or other disposition of all or substantially all the assets of the Obligor or the Issuer; the receivership, insolvency, bankruptcy, assignment for the benefit of creditors, reorganization, arrangement, composition with creditors or readjustment or other similar proceedings affecting the Obligor or the Issuer or any of the assets of either of them, or any allegation or contest of the validity of this Agreement or any of the Operative Documents, in any such proceedings;

(h) any other circumstance or happening whatsoever, whether or not similar to any of the foregoing, and any other event or action that would, in the absence of this clause, result in the release or discharge by operation of law of the Obligor from the performance or observance of any obligation, covenant or agreement contained in this Agreement.

No setoff, counterclaim, reduction or diminution of any obligation, or any defense of any kind or nature which the Obligor has or may have against the Issuer or the Trustee shall be available hereunder to the Obligor against the Bank.

SECTION 5. Representations and Warranties. The Obligor represents and warrants as of the Execution Date, as follows:

(a) The Obligor is a corporation duly incorporated, validly existing and in good standing under the laws of the State of Delaware.

(b) The execution, delivery and performance by the Obligor of this Agreement, the Loan Agreement, the Pledge and Security Agreement and the Collateral Documents, as the case may be, are within the Obligor's corporate powers, have been duly authorized by all necessary

corporate action, do not contravene or violate (i) the Articles of Incorporation or Bylaws of the Obligor, (ii) any law, order, rule or regulation applicable to the Obligor, (iii) any material contract or agreement to which the Obligor is a party or by which it is bound and does not result in or require the creation of any lien, security interest or other charge or encumbrance (other than pursuant to the Collateral Documents, this Agreement, the Indenture, the Pledge and Security Agreement or the Loan Agreement) upon or with respect to any of its properties.

(c) All registration with, authorizations by, or approvals of any governmental body required to be obtained by the Obligor for its execution, delivery and performance of this Agreement, the Loan Agreement, the Pledge and Security Agreement and the Collateral Documents have been obtained and remain in full force and effect.

(d) This Agreement, the Loan Agreement, the Pledge and Security Agreement and the Collateral Documents are legal, valid and binding obligations of the Obligor, enforceable against it in accordance with their respective terms, except as enforceability may be subject, to the effect of any applicable bankruptcy, insolvency, reorganization, moratorium or similar law affecting creditors' rights generally.

(e) There is not pending or, to the knowledge of the Obligor, threatened any action or proceeding before any court, governmental agency or arbitrator against or affecting the Obligor which, if determined adversely to the Obligor, would materially and adversely affect the financial condition or operations of the Obligor.

(f) The Obligor has not incurred any material accumulated funding deficiency within the meaning of the Employment Retirement Income Security Act of 1974 ("ERISA") and has not incurred any material liability to the Pension Benefit Guaranty Corporation ("PBGC") in connection with any employee benefit plan established or maintained by the Obligor or any Guarantor.

(g) The Obligor is not in default in the payment of any indebtedness for borrowed money in an amount in excess of Fifty Thousand Dollars (\$50,000) or under the terms and provisions of any agreement or instrument evidencing any such indebtedness.

(h) No representation or warranty of the Obligor contained in this Agreement or in any of the Collateral Documents, and no statement contained in any certificate, schedule, list, financial statement or other instrument furnished to the Bank by or on behalf of the Obligor contains, or will contain, any untrue statement of a material fact, or omits, or will omit, to state a material fact necessary to make the statements contained herein or therein not misleading in any material respect when made.

(i) The Obligor has obtained or will obtain at the appropriate times all licenses, permits, authorizations, consents or approvals from each governmental authority necessary for the operation of the Project; and all such licenses, permits, authorizations, consents or approvals previously obtained, if any, are in full force and effect.

(j) No Event of Default has occurred under the Loan and Security Agreement dated March 28, 2003 between the Obligor, Priority Fulfillment Services of Canada, Inc. and Bank, as the same may be amended from time to time ("Credit Agreement") or event which with the

giving of notice or passage of time or both would constitute an Event of Default under the Credit Agreement shall have occurred and be continuing.

All of the Obligor's representations and warranties set forth in the Credit Agreement, which relate to the Obligor, including, without limitation, the representations and warranties in Section 5 of the Credit Agreement, are hereby incorporated herein by reference as if set forth fully herein as continuing representations and warranties of the Obligor, and shall remain continuing representations and warranties hereunder, notwithstanding any termination of the Credit Agreement after the date hereof.

**SECTION 6. Affirmative Covenants.** So long as a drawing is available under the Letter of Credit, and thereafter until Obligor's liabilities and obligations under this Agreement have been satisfied in full, the Obligor shall:

- (a) **Preservation of Corporate Existence.** Etc. Preserve and maintain its corporate existence and such of its rights (charter and statutory) and privileges as are material to its business and operations; and qualify and remain qualified as a foreign corporation in each jurisdiction in which such qualification is material to its business and operations or the ownership of its properties.
- (b) **Inspection Rights.** At any reasonable time during normal business hours and upon reasonable notice and from time to time, permit the Bank or any agents or representatives thereof to examine and make copies of and abstracts from the records and books of account of, and visit the properties of the Obligor and the Project, and to discuss the affairs, finances and accounts of the Obligor with any of its officers and directors.
- (c) **Reporting Requirements.** Furnish to the Bank the following:
  - (i) as soon as possible after becoming aware of the occurrence of each Event of Default or each event which, with the giving of notice or lapse of time, or both, would constitute an Event of Default, a written statement from the chief financial officer (or in his absence, a responsible senior officer) of the Obligor setting forth details of such Event of Default or event and the action which the Obligor has taken or proposes to take with respect thereto; and
  - (ii) such other information respecting the business, properties, or the financial condition or operations of the Obligor as the Bank may from time to time reasonably request.
- (d) **Optional Redemption of Bonds.** The Obligor shall cause the Bonds to be optionally redeemed at the times and in the amounts set forth in Exhibit "B" attached hereto. On the date hereof, Obligor shall deliver an instruction to the Trustee in the form of Exhibit "C" to redeem the Bonds in accordance with the schedule set forth on Exhibit "B". On the first business day of each month of each year, commencing January 3, 2005, the Obligor shall pay to the Bank for deposit to an interest bearing cash collateral account one twelfth (1/12th) of the annual redemption payment next coming due, which moneys shall be used to reimburse the Bank for payments by the Bank of drafts submitted by the Trustee under the Letter of Credit.

(e) Comply with Covenants. Comply with all affirmative, negative and financial covenants contained in the Credit Agreement (as the same may be amended, waived or modified from time to time), as if explicitly set forth herein in their entirety ("Credit Agreement Covenants"). So long as this Agreement remains in full force and effect, the Credit Agreement Covenants, as incorporated herein by reference in accordance with the foregoing, shall remain in full force and effect hereunder notwithstanding any termination of the Credit Agreement after the date hereof.

**SECTION 7. Negative Covenants of the Obligor.** So long as a drawing is available under the Letter of Credit and thereafter so long as any indebtedness remains outstanding hereunder, the Obligor agrees that it will not, without the prior written consent of the Bank:

- (a) Amendment of Indenture or Loan Agreement. Enter into or agree to any amendment, change or modification of, or any waiver of any provision of, the Indenture or the Loan Agreement.
- (b) Misrepresentation. Furnish the Bank with any certificate or other document that contains any untrue statement of a material fact or omits to state a material fact necessary to make such certificate or document not misleading in light of the circumstances under which it was furnished.
- (c) Use of Proceeds. Use or permit the use of the proceeds of the Bonds for a purpose other than permitted under the Loan Agreement.

**SECTION 8. Events of Default.**

(a) The occurrence of any of the following events shall be an "Event of Default" hereunder unless waived by the Bank pursuant to Section 10 hereof:

- (i) Any representation or warranty made by the Obligor pursuant to Section 5 hereof shall prove to have been untrue in any material respect when made; or
- (ii) The Obligor shall fail to pay when due any amount specified in Section 1 hereof; or
- (iii) The Obligor shall fail to perform or observe any of its obligations or covenants under, or shall fail to comply with any of the provisions of Section 6 or Section 7; or
- (iv) The Obligor shall fail to perform or observe any of its obligations or covenants under Section 6 or 7 of the Credit Agreement which gives rise to an Event of Default under the Credit Agreement, taking into account applicable periods of notice and cure under Section 8 of the Credit Agreement; or
- (v) The Obligor shall fail to perform or observe any other term, covenant or agreement herein contained and continuance thereof for thirty (30) days, or the Obligor or any guarantor of the Obligor's obligations to the Bank ("Guarantor") shall fail to perform or observe any term, covenant or agreement in any other agreement with the Bank to

which it may be a party and such failure shall continue unremedied beyond any applicable period of cure; or

(vi) Any material provision of the Agreement or any of the Collateral Documents shall at any time for any reason cease to be valid and binding on the Obligor, or shall be declared to be null or void, or the validity or enforceability of any material provision of this Agreement shall at any time for any reason be contested by the Obligor, or the Obligor, shall deny that it has any or further liability or obligation under this Agreement; or

(vii) An Event of Default under and as defined in the Loan Agreement, the Credit Agreement, the Indenture and/or the Collateral Documents shall have occurred and be continuing without the same being cured or waived pursuant to the terms thereof (it being the intent of the parties that so long as this Agreement remains in full force and effect the Events of Default set forth in the Credit Agreement shall be Events of Default hereunder regardless of whether the Credit Agreement shall be terminated after the date hereof but before termination of this Agreement).

(b) If any of the Events of Default specified in subsection (a) above shall have occurred and be continuing, in addition to the Bank's other remedies available under the Loan Agreement, the Indenture, the Pledge and Security Agreement, the Collateral Documents, or such other documents executed in connection herewith, or any other remedy available at law or in equity, then the Bank may, at any time and in its sole discretion, but shall not be obligated to, accelerate any indebtedness of Obligor to Bank under Section 1(b), or terminate its commitment to issue the Letter of Credit or, if the Letter of Credit shall have been issued, may elect to give notice to the Trustee pursuant to the Indenture thereby requiring the Trustee to declare the principal of all Bonds then outstanding and the interest accrued thereon and any premium thereon and thereby owing to be immediately due and payable and/or require the Obligor to deliver cash collateral to the Bank in the amount equal to the maximum amount that may be available to be drawn at any time under the Letter of Credit.

SECTION 9. Collateral Security. To secure full and timely performance of the Obligor's covenants set out in this Agreement and to secure the repayment of all other moneys owing by the Obligor to the Bank whensoever arising and whether associated with this Agreement or otherwise (i) the Obligor has granted to the Bank first perfected security interests in all the Obligor's accounts receivable, inventory, machinery and equipment and other tangible and intangible personal property pursuant to certain previously executed loan documents and (ii) the Obligor has caused to be delivered to the Bank the guaranty described in attached Exhibit "D". The security agreements creating such liens in favor of the Bank and the various guaranties agreements shall be granted pursuant to documentation satisfactory in form and substance to the Bank and are herein collectively called the "Collateral Documents".

SECTION 10. Amendments, Waivers, Etc. No amendments or waiver of any provision of this Agreement nor consent to any departure by the Obligor therefrom shall in any event be effective unless the same shall be in writing and signed by the Bank and the Obligor, and then such amendment, waiver or consent shall be effective only in the specific instance and for the



specific purpose for which given. No amendment, waiver or consent with respect to any provision of this Agreement shall affect any other provision of this Agreement.

SECTION 11. Addresses for Notices. All notices and other communications provided for hereunder shall be in writing and mailed or delivered as follows:

**if to the Obligor:**

Priority Fulfillment Services, Inc.

500 N. Central Expressway  
5th Floor  
Plano, Texas 75074  
Attn: Thomas Madden

**if to the Bank:**

Comerica Bank  
801 East Campbell  
Suite 142  
Richardson, Texas 75081  
Attention: William Stuart Bell

or as to any party, at such other address as shall be designated by such party in a written notice to the other party. All such notices and other communications shall, when mailed, be effective three days after the date of deposit in the mails, addressed as aforesaid.

SECTION 12. No Waiver; Remedies. No failure on the part of the Bank to exercise, and no delay in exercising, any right hereunder shall operate as a waiver thereof; nor shall any single or partial exercise of any right hereunder preclude any other or further exercise thereof or the exercise of any other right. The remedies herein provided are cumulative and exclusive of any remedies provided by law.

SECTION 13. Indemnification. The Obligor hereby indemnifies and holds the Bank harmless from and against any and all claims, damages, losses, liabilities, costs or expenses whatsoever which the Bank may incur (or which may be claimed against the Bank by any person or entity whatsoever) :

(i) by reason of any untrue statement or alleged untrue statement of fact contained in the Private Placement Memorandum or any amendment or supplement thereto, in the Sections entitled "The Obligor and the Use of Proceeds," "The Letter of Credit," "The Loan Agreement" and "The Reimbursement Agreement" insofar as the aforesaid Sections provide summary descriptions of the matters contained therein in the Private Placement Memorandum or any amendment or supplement thereto, or the omission or alleged omission to state therein facts necessary to make such statements, in the light of the circumstances under which they were made, not misleading; provided, however, that, the Obligor shall not be required to indemnify the Bank with respect to information concerning the Bank in the Appendix to the Private Placement Memorandum

(the "Bank Information") which is finally determined to contain an untrue statement of a material fact or omit to state a material fact necessary to make the statements in the Bank Information, in the light of the circumstances under which they were made, not misleading; or

(ii) by reason of or in connection with the execution and delivery or transfer of, or payment or failure to pay under, the Letter of Credit; provided, however, that the Obligor shall not be required to indemnify the Bank pursuant to this clause (ii) for any claims, damages, losses, liabilities, costs or expenses to the extent, but only to the extent, caused by (a) the willful misconduct or gross negligence of the Bank or (b) the Bank's willful or grossly negligent failure to pay under the Letter of Credit after the presentation to it by the Trustee of a drawing and certificates strictly complying with the terms and conditions of the Letter of Credit.

Nothing in this Section 13 is intended, nor shall be deemed, to limit the Obligor's reimbursement obligation contained in Section 1 hereof.

**SECTION 14. Continuing Obligation.** This Agreement is a continuing obligation and shall (i) be binding upon the Obligor, its successors and assigns, and (ii) inure to the benefit of and be binding upon and be enforceable by the Bank and its successors, transferees and assigns; provided, however, that the Obligor may not assign all or any part of this Agreement without the prior written consent of the Bank. The Obligor's warranties and representations made in Section 5 of this Agreement shall survive the delivery and performance of all documents and agreements contemplated by this Agreement.

**SECTION 15. Transfer of Letter of Credit.** The Letter of Credit first issued by the Bank pursuant to Section 2 hereof may be transferred and each successor Letter of Credit may be successively transferred, all in accordance with the terms of such first Letter of Credit.

**SECTION 16. Liability of the Bank.** The Obligor assumes all risks of the acts or omissions of the Trustee and any beneficiary or transferee of the Letter of Credit with respect to its use of the Letter of Credit. Neither the Bank nor any of its officers or directors shall be liable or responsible for: (a) the use which may be made of the Letter of Credit or for any acts or omissions of the Trustee and any beneficiary or transferee in connection therewith; (b) the validity, sufficiency or genuineness of documents, or of any endorsement(s) thereof, even if such documents should in fact prove to be in any or all respects invalid, insufficient, fraudulent or forged; (c) payment by the Bank in good faith made against presentation of documents which do not comply fully with the terms of the Letter of Credit; or (d) any other circumstances whatsoever in making or failing to make payment under the Letter of Credit, except only that the Obligor shall have a claim against the Bank, and the Bank shall be liable to the Obligor, to the extent, but only to the extent, of any direct, as opposed to consequential, damages suffered by the Obligor which the Obligor proves were caused by (i) the Bank's willful misconduct or gross negligence, (ii) the Bank's willful, grossly negligent or bad faith failure to pay under the Letter of Credit after the presentation to it by the Trustee or a successor trustee under the Indenture of a sight draft and certificate strictly complying with the terms and conditions of the Letter of Credit or (iii) the Bank's bad faith payment under the Letter of Credit after presentation to it by the Trustee or a successor trustee under the Indenture of a sight draft and certificate which do not

comply fully with the terms and conditions of the Letter of Credit. In furtherance and not in limitation of the foregoing, the Bank may accept documents that appear on their face to be in order, without responsibility for further investigation, regardless of any notice or information to the contrary.

**SECTION 17. Costs, Expenses and Taxes.** The Obligor agrees to pay on demand all reasonable costs and expenses in connection with the preparation, execution, delivery, filing, recording, and administration of this Agreement and the monitoring of the construction of the Project, any other documents which may be delivered in connection with this Agreement and any transfer of the Letter of Credit including, without limitation, the reasonable fees and out-of-pocket expenses of counsel for the Bank, with respect thereto and with respect to advising the Bank as to its rights and responsibilities under this Agreement and all costs and expenses, if any, in connection with the enforcement of this Agreement and such other documents which may be delivered in connection with this Agreement, including, but not limited to the Collateral Documents. In addition, the Obligor shall pay any and all stamp and other taxes and fees payable or determined to be payable in connection with the execution, delivery, filing and recording of this Agreement and such other documents and agrees to save the Bank harmless from and against any and all liabilities with respect to or resulting from any delay in paying or omission to pay such taxes and fees.

**SECTION 18. Disbursements.** The Trustee shall be authorized to disburse the proceeds of the Bonds pursuant to the terms of the Indenture upon presentation by the Obligor of a requisition certificate conforming to the requirements therefor set forth in the Loan Agreement and herein, including endorsement of each requisition certificate by the Bank. The Obligor acknowledges and agrees that the Bank shall only be required to execute requisition certificates and thereby authorize disbursements to the Obligor (a) provided that no Event of Default has occurred under this Agreement, the Pledge and Security Agreement or the Collateral Documents and no event which with notice and/or the passage of time would become an Event of Default under this Agreement, the Pledge and Security Agreement or the Collateral Documents has occurred, and (b) the request for draw is in compliance with the Bank's usual requirements for equipment lending, including but not limited to (i) approval of disbursements by Bank; (ii) receipt by the Bank of copies of all invoices and proof of delivery with respect to all machinery and equipment for which payment is being sought and (iii) disbursement of no more than one hundred percent (100%) of the costs of machinery and equipment (including, without limitation, soft costs). All such calculations shall be performed by the Bank or its agent using a methodology satisfactory to the Bank in its sole discretion.

**SECTION 19. Severability.** Any provision of this Agreement which is prohibited, unenforceable or not authorized in any jurisdiction shall, as to such jurisdiction, be ineffective to the extent of such prohibition, unenforceability or nonauthorization without invalidating the remaining provisions hereof or affecting the validity, enforceability or legality of such provision in any other jurisdiction.

**SECTION 20. Waiver of Jury Trial.** The Obligor and the Bank hereby irrevocably waive the right to trial by jury with respect to any and all actions or proceedings at any time in which Obligor and the Bank are parties arising out of this Agreement or the other documents contemplated hereby.

SECTION 21. Jurisdiction. Obligor hereby irrevocably submits to the non-exclusive jurisdiction of any United States Federal or Michigan state court sitting in any action or proceeding arising out of or relating to this Agreement or the Letter of Credit and the Obligor hereby irrevocably agrees that all claims in respect of such action or proceeding may be heard and determined in any such United States Federal or Michigan state court. The Obligor irrevocably consents to the service of any and all process in any such action or proceeding brought in any court in or of the State of Michigan by the delivery of copies of such process to the Obligor at its address specified in Section 10 hereof or by certified mail directed to such address.

SECTION 22. Authorized Signers. The following officers of the Obligor are authorized on behalf of the Obligor to execute and deliver to the Bank all documents and instruments related to any amendments to the Letter of Credit:

Name	Title	Signature
Mark C. Layton	Chief Executive Officer	_____
Thomas J. Madden	Chief Financial Officer	_____

SECTION 23. Governing Law. This Agreement shall be governed by, and construed in accordance with, the laws of the State of Michigan.

SECTION 24. Headings. Section headings in this Agreement are included herein for convenience of reference only and shall not constitute a part of this Agreement for any other purpose.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be duly executed and delivered by their respective officers thereunto duly authorized as of the date first above written.

In the Presence of:

\_\_\_\_\_

\_\_\_\_\_

PRIORITY FULFILLMENT  
SERVICES, INC.

By: \_\_\_\_\_

Its: \_\_\_\_\_

COMERICA BANK

By: \_\_\_\_\_

William Stuart Bell

Its: \_\_\_\_\_

## EXHIBIT "B"

Obligor shall optionally redeem Bonds in the following amounts on the first business day of January of each year, commencing January 3, 2006.

YEAR	AMOUNT OF REDEMPTION
2006	\$500,000
2007	\$500,000
2008*	\$800,000
2009	\$800,000
2010	\$800,000
2011	\$800,000
2012	\$800,000

\*These dates are for informational purposes only and will apply only if the Bank extends the expiration date of the Letter of Credit. There is no commitment or obligation on the part of the Bank to extend the expiration date of the Letter of Credit.

**EXHIBIT "C"**

**REDEMPTION NOTICE**

To: U.S. Bank National Association, as trustee

Re: \$5,000,000 principal amount of the Issuer's Variable Rate Demand Limited Obligation Revenue Bonds (Priority Fulfillment Services, Inc. Project), Series 2004 (the "Bonds")

Date: December 29, 2004

The undersigned, the Obligor (as defined in the Trust Indenture, dated as of November 1, 2004, pursuant to which the Bonds were issued (the "Indenture")) hereby gives notice of redemption to you as Trustee with respect to the Bonds pursuant to Section 401(a) of the Indenture. You are hereby directed to redeem the Bonds in the following amounts on the first business day of January of each year, commencing January 1, 2006, as follows in accordance with the provisions of the Indenture:

YEARS	AMOUNTS
2006	\$ 500,000
2007	\$ 500,000
2008	\$ 800,000
2009	\$ 800,000
2010	\$ 800,000
2011	\$ 800,000
2012	\$ 800,000

This notice may only be revoked at the written direction of the undersigned, with the written concurrence of Comerica Bank and shall be of no further force and effect on and after the Conversion Date (as defined in the Indenture).

**PRIORITY FULFILLMENT  
SERVICES, INC.**

By:\_\_\_\_\_

Its:\_\_\_\_\_

The foregoing notice is hereby accepted:  
U.S. Bank National Association, as trustee

By:\_\_\_\_\_

Its:\_\_\_\_\_

**EXHIBIT 10.57**

**PRIORITY FULFILLMENT SERVICES, INC.**

**FIRST AMENDED AND RESTATED  
LOAN AND SECURITY AGREEMENT**



This FIRST AMENDED AND RESTATED LOAN AND SECURITY AGREEMENT is entered into as of December \_\_, 2004, by and between Comerica Bank ("Bank") and Priority Fulfillment Services, Inc. ("Borrower").

## **RECITALS**

Borrower wishes to obtain credit from time to time from Bank, and Bank desires to extend credit to Borrower. This Agreement sets forth the terms on which Bank will advance credit to Borrower, and Borrower will repay the amounts owing to Bank.

## **AGREEMENT**

The parties agree as follows:

### **1. DEFINITIONS AND CONSTRUCTION.**

1.1 Definitions. As used in this Agreement, all capitalized terms shall have the definitions set forth on Exhibit A. Any term used in the Code and not defined herein shall have the meaning given to the term in the Code.

1.2 Accounting Terms. Any accounting term not specifically defined on Exhibit A shall be construed in accordance with GAAP and all calculations shall be made in accordance with GAAP. The term "financial statements" shall include the accompanying notes and schedules.

### **2. LOAN AND TERMS OF PAYMENT.**

#### **2.1 Credit Extensions.**

(a) Promise to Pay. Borrower promises to pay to Bank, in lawful money of the United States of America, the aggregate unpaid principal amount of all Credit Extensions made by Bank to Borrower, together with interest on the unpaid principal amount of such Credit Extensions at rates in accordance with the terms hereof.

#### **(b) Revolving Advances.**

(i) Amount. Subject to and upon the terms and conditions of this Agreement (1) Borrower may request Advances in an aggregate outstanding amount not to exceed the lesser of (A) the Committed Revolving Line or (B) the Borrowing Base, less any amounts outstanding under the Letter of Credit Sublimit, and (2) amounts borrowed pursuant to this Section 2.1(b) may be repaid and reborrowed at any time prior to the Revolving Maturity Date, at which time all Advances under this Section 2.1(b) shall be immediately due and payable. Borrower may prepay any Advances without penalty or premium.

(ii) Form of Request. Whenever Borrower desires an Advance, Borrower will notify Bank by facsimile transmission or telephone no later than 3:00 p.m. Pacific time, on the Business Day that the Advance is to be made. Each such notification shall be promptly confirmed by a Payment/Advance Form in substantially the form of Exhibit C. Bank is authorized to make Advances under this Agreement, based upon instructions received from a Responsible Officer or a designee of a Responsible Officer, or without instructions, but upon prior notice to Borrower, if in Bank's discretion such Advances are necessary to meet Obligations which have become due and remain unpaid. Bank shall be entitled to rely on any telephonic notice given by a person who Bank reasonably believes to be a Responsible Officer or a designee thereof, and Borrower shall indemnify and hold Bank harmless for any damages or loss suffered by Bank as a result of such reliance. Bank will credit the amount of Advances made under this Section 2.1(b) to Borrower's deposit account.

(iii) Letter of Credit Sublimit. Subject to the availability under the Committed Revolving Line, and in reliance on the representations and warranties of Borrower set forth herein, at any time and from time to time from the date hereof through the Business Day immediately prior to the Revolving Maturity Date, Bank shall issue for the account of Borrower such Letters of Credit as Borrower may request by delivering to Bank a duly executed letter of credit application on Bank's standard form; provided, however, that the outstanding and undrawn amounts under all such Letters of Credit (i) shall not at any time exceed the Letter of Credit Sublimit, and (ii) shall be deemed to constitute Advances for the purpose of calculating availability under the Committed Revolving Line. Any drawn but unreimbursed amounts under any Letters of Credit shall be charged as Advances against the Committed Revolving Line. All Letters of Credit shall be in form and substance acceptable to Bank in its sole discretion and shall be subject to the terms and conditions of Bank's form application and letter of credit agreement. Borrower will pay any standard issuance and other fees that Bank notifies Borrower will be charged for issuing and processing Letters of Credit. Unless Borrower shall have deposited with Bank cash collateral in an amount sufficient to cover all undrawn amounts under each such Letter of Credit and Bank shall have agreed in writing, no Letter of Credit shall have an expiration date that is later than the Revolving Maturity Date. If Borrower has not secured to Bank's satisfaction its obligations with respect to any Letters of Credit by the Revolving Maturity Date, then, effective as of such date, the balance in any deposit accounts held by Bank and the certificates of deposit issued by Bank in Borrower's name (and any interest paid thereon or proceeds thereof, including any amounts payable upon the maturity or liquidation of such certificates), shall automatically secure such obligations to the extent of the then outstanding and undrawn Letters of Credit. Borrower authorizes Bank to hold such balances in pledge and to decline to honor any drafts thereon or any requests by Borrower or any other Person to pay or otherwise transfer any part of such balances for so long as the Letters of Credit are outstanding. The Standby Letter of Credit is not subject to the Letter of Credit Sublimit and is not a "Letter of Credit" for purposes of this Section 2.1(b)(iii).

(c) Equipment Advances.

(i) Subject to and upon the terms and conditions of this Agreement, Bank agrees to make advances (each an "Equipment Advance" and, collectively, the "Equipment Advances") to Borrower in two tranches, Tranche A and Tranche B. Borrower may request Equipment Advances under Tranche A at any time from the date hereof through the Tranche A Availability End Date. Borrower may request Equipment Advances under Tranche B at any time from the Tranche A Availability End Date through the Tranche B Availability End Date. The aggregate outstanding amount at any time of Tranche A Equipment Advances and Tranche B Equipment Advances shall not exceed the Maximum Equipment Line Availability. Each Equipment Advance shall not exceed 100% of the invoice amount of equipment and software approved by Bank from time to time (which Borrower shall, in any case, have purchased within 90 days of the date of the corresponding Equipment Advance; provided that the first Equipment Advance may finance equipment and software purchased by Borrower no earlier than July 1, 2004, so long as the amount advanced with respect to such equipment shall not exceed \$225,000), including taxes, shipping, warranty charges, freight discounts and installation expense (collectively, "Soft Costs"); provided that the aggregate amount of Equipment Advances made for Soft Costs shall not exceed 20% of the aggregate principal amount of Equipment Advances.

(ii) Interest shall accrue from the date of each Equipment Advance at the rate specified in Section 2.3(a), and shall be payable in accordance with Section 2.3(c). Any Equipment Advances that are outstanding under Tranche A on the Tranche A Availability End Date shall be payable in 30 equal monthly installments of principal, plus all accrued interest, beginning on July \_\_, 2005, and continuing on the same day of each month thereafter through December \_\_, 2007, at which time all amounts due in connection with Tranche A Equipment Advance made under this

Section 2.1(c) shall be immediately due and payable. Any Equipment Advances that are outstanding under Tranche B on the Tranche B Availability End Date shall be payable in 30 equal monthly installments of principal, plus all accrued interest, beginning on January \_\_, 2006, and continuing on the same day of each month thereafter through June \_\_, 2008, at which time all amounts due in connection with Tranche B Equipment Advance made under this Section 2.1(c) and any other amounts due under this Agreement

shall be immediately due and payable. Equipment Advances, once repaid, may not be reborrowed. Borrower may prepay any Equipment Advances without penalty or premium.

(iii) When Borrower desires to obtain an Equipment Advance, Borrower shall notify Bank (which notice shall be irrevocable) by facsimile transmission to be received no later than 3:00 p.m. Pacific time on the day on which the Equipment Advance is to be made. Such notice shall be substantially in the form of Exhibit C. The notice shall be signed by a Responsible Officer or its designee and include a copy of the invoice for any Equipment to be financed.

(d) Standby Letter of Credit. Subject to the terms and conditions of this Agreement, and in reliance on the representations and warranties of Borrower set forth herein, Bank shall issue for the account of Borrower the Standby Letter of Credit. The Standby Letter of Credit shall be in form and substance acceptable to Bank in its sole discretion and shall be subject to the terms and conditions of Bank's form application and letter of credit agreement. Borrower will reimburse Bank for any drawn amounts under the Standby Letter of Credit in accordance with the terms of the Reimbursement Agreement. All drawn amounts under the Standby Letter of Credit shall (i) accrue interest at the rates set forth in the Reimbursement Agreement from the date drawn until paid in full and (ii) be paid in accordance with the terms of the Reimbursement Agreement.

(e) Equipment Term Loan.

(i) Bank has heretofore made a term loan (the "Equipment Term Loan") to Borrower to refinance certain equipment leases and for equipment acquisitions. The Equipment Term Loan was advanced in three tranches, herein called "Existing Tranche A", "Existing Tranche B," and "Existing Tranche C."

(ii) Interest accrues on the Equipment Term Loan at the rate specified in Section 2.3(a), and shall be payable in accordance with Section 2.3(c). The Existing Tranche A is payable in 15 equal installments of principal, plus all accrued interest, beginning on January 15, 2005, and continuing on the same day of each month thereafter until February 15, 2006, at which time all amounts due in connection with the Existing Tranche A shall be immediately due and payable. The Existing Tranche B is payable in 21 equal monthly installments of principal, plus all accrued interest, beginning on January 1, 2005, and continuing on the same day of each month thereafter through September 10, 2006, at which time all amounts due in connection with the Existing Tranche B shall be immediately due and payable. The Existing Tranche C is payable in 21 equal monthly installments of principal, plus all accrued interest, beginning on January 1, 2005 and continuing on the same day of each month thereafter through September 10, 2006, at which time all amounts due in connection with the Existing Tranche C shall be immediately due and payable. The Equipment Term Loan, once repaid, may not be reborrowed. Borrower may prepay the Equipment Term Loan, or any portion thereof, without penalty or premium.

2.2 Overadvances. If the aggregate amount of the outstanding Advances exceeds the lesser of the Committed Revolving Line or the Borrowing Base at any time, Borrower shall immediately pay to Bank, in cash, the amount of such excess.

### 2.3 Interest Rates, Payments, and Calculations.

(a) Interest Rates.

(i) Advances. Except as set forth in Section 2.3(b), the Advances shall bear interest, on the outstanding daily balance thereof, at a variable rate equal to 1.0% above the Prime Rate.

(ii) Equipment Advances. Except as set forth in Section 2.3(b), the Equipment Advances shall bear interest, on the outstanding daily balance thereof, at a rate equal to 1.5% above the Prime Rate.

(iii) Equipment Term Loan. Except as set forth in

Section 2.3(b), the Equipment Term Loan shall bear interest, on the outstanding daily balance thereof, at a rate equal to 1.5% above the Prime Rate.

(iv) Standby Letter of Credit. Any drawn amount under the Standby Letter of Credit shall bear interest, on the outstanding daily balance thereof, at the rates set forth in the Reimbursement Agreement.

(b) Late Fee; Default Rate. If any payment is not made within 10 days after the date such payment is due, Borrower shall pay Bank a late fee equal to the lesser of (i) 5% of the amount of such unpaid amount or

(ii) the maximum amount permitted to be charged under applicable law. All Obligations shall bear interest, from and after the occurrence and during the continuance of an Event of Default, at a rate equal to 5 percentage points above the interest rate applicable immediately prior to the occurrence of the Event of Default.

(c) Payments. Interest hereunder shall be due and payable on the 15th of each month during the term hereof. Bank shall, at its option, charge such interest, all Bank Expenses, and all Periodic Payments against any of Borrower's deposit accounts or against the Committed Revolving Line, in which case those amounts shall thereafter accrue interest at the rate then applicable hereunder. Any interest not paid when due shall be compounded by becoming a part of the Obligations, and such interest shall thereafter accrue interest at the rate then applicable hereunder.

(d) Computation. In the event the Prime Rate is changed from time to time hereafter, the applicable rate of interest hereunder shall be increased or decreased, effective as of the day the Prime Rate is changed, by an amount equal to such change in the Prime Rate. All interest chargeable under the Loan Documents shall be computed on the basis of a 360 day year for the actual number of days elapsed.

(e) Limitation on Interest. Borrower and Bank intend to contract in strict compliance with applicable usury law from time to time in effect. In furtherance thereof such persons stipulate and agree that none of the terms and provisions contained in the Loan Documents shall ever be construed to provide for interest in excess of the maximum amount of interest permitted to be charged by applicable usury law from time to time in effect. If, notwithstanding the foregoing, any amount constituting interest is nonetheless charged or collected in excess of the maximum amount of interest permitted to be charged by applicable usury law from time to time in effect, then such excess shall, at the option of the payee thereof, be credited on the amount of the obligations owed to such payee or refunded by such payee to the payor thereof.

2.4 Crediting Payments. Prior to the occurrence of an Event of Default, Bank shall credit a wire transfer of funds, check or other item of payment to such deposit account or Obligation as Borrower specifies. After the occurrence of an Event of Default, the receipt by Bank of any wire transfer of funds, check, or other item of payment shall be immediately applied to conditionally reduce Obligations, but shall not be considered a payment on account unless such payment is of immediately available federal funds or unless and until such check or other item of payment is honored when presented for payment. Notwithstanding anything to the contrary contained herein, any wire transfer or payment received by Bank after 12:00 noon Pacific time shall be deemed to have been received by Bank as of the opening of business on the immediately following Business Day. Whenever any payment to Bank under the Loan Documents would otherwise be due (except by reason of acceleration) on a date that is not a Business Day, such payment shall instead be due on the next Business Day, and additional fees or interest, as the case may be, shall accrue and be payable for the period of such extension.

2.5 Fees. Borrower shall pay to Bank the following:

(a) Facility Fee. On the Closing Date, a Facility Fee equal to \$5,000, which shall be nonrefundable.

(b) Letter of Credit Fees. On the Closing Date and on each December 1 thereafter, a letter of credit fee pursuant to, and in accordance with, the terms of Section 1(c) of the Reimbursement Agreement.

(c) Bank Expenses. On the Closing Date, all Bank Expenses incurred through the Closing Date, and, after the Closing Date, all Bank Expenses, as and when they become due.

2.6 Term. This Agreement shall become effective on the Closing Date and, subject to Section 13.7, shall continue in full force and effect for so long as any Obligations remain outstanding or Bank has any obligation to make Credit Extensions under this Agreement. Notwithstanding the foregoing, Bank shall have the right to terminate its obligation to make Credit Extensions under this Agreement immediately and without notice upon the occurrence and during the continuance of an Event of Default.

2.7 Equipment Term Loan and Equipment Advances Following Termination of Committed Revolving Line. In the event all Advances are paid in full and the Committed Revolving Line is terminated prior to the payment in full of the Equipment Term Loan and the Equipment Advances, unless Borrower complies with the requirements of either clause (a) or (b) of this Section 2.7, this Agreement will remain in full force and effect (except as to the availability of the Committed Revolving Line) and Bank's security interest in the Collateral will continue to secure Borrower's obligations under the Equipment Term Loan and the Equipment Advances.

(a) Borrower may, at its option, pay to Bank in full all amounts outstanding (all unpaid principal and accrued interest through the date of payoff) under the Equipment Term Loan and the Equipment Advances, whereupon

(i) Borrower's rights to receive, and Bank's obligations to make, Equipment Advances shall automatically terminate, (ii) Bank shall release its security interests in the Collateral, and (iii) this Agreement shall terminate (subject to Section 13.7 hereof); or

(b) Borrower may, at its option, concurrently with the termination of the Committed Revolving Line, deposit with Bank (or an Affiliate of Bank) an amount equal to the aggregate principal balance of the Equipment Term Loan and the Equipment Advances then outstanding (the "Additional Cash Collateral") and execute a pledge and security agreement in favor of Bank, in form and substance satisfactory to Bank, pursuant to which Borrower shall grant a first priority security interest in favor of Bank in the Additional Cash Collateral. Upon receipt of the Additional Cash Collateral and executed pledge and security agreement, Bank will release its security interest in all Collateral other than the Additional Cash Collateral and all of the covenants contained in Articles 6 and 7 hereof (other than 6.1, 6.2(b)-(g) and 6.4) shall terminate and be of no further force or effect. Bank agrees that it will, from time to time upon written request by Borrower, release its security interest on, and distribute in accordance with Borrower's written directions, Additional Cash Collateral in an amount equal to the amount by which the Additional Cash Collateral exceeds the aggregate outstanding principal balance of the Equipment Term Loan and the Equipment Advances as of the date of such request. When all Equipment Advances, the Equipment Term Loan, and other Obligations have been paid in full, Bank shall release its security interest in any remaining Additional Cash Collateral.

### 3. CONDITIONS OF LOANS.

3.1 Conditions Precedent to Initial Credit Extension. The obligation of Bank to make the initial Credit Extension is subject to the condition precedent that Bank shall have received, in form and substance satisfactory to Bank, the following:

(a) this Agreement;

(b) an officer's certificate of Borrower with respect to incumbency and resolutions authorizing the execution and delivery of this Agreement;

(c) a financing statement (Form UCC-1);

(d) an intellectual property security agreement;

(e) agreement to provide insurance;

(f) payment of the fees and Bank Expenses then due specified in Section 2.5;

- (g) current SOS Reports indicating that except for Permitted Liens, there are no other security interests or Liens of record in the Collateral;
- (h) current financial statements, including audited statements for Borrower's most recently ended fiscal year, together with an unqualified opinion, in accordance with Section 6.2;
- (i) an appraisal of (i) the equipment to be purchased by Borrower with the proceeds of the Bonds and (ii) all other Equipment of Borrower, reflecting an aggregate orderly liquidation value of at least \$3,500,000 (or, if such appraisal reflects an aggregate orderly liquidation value of less than \$3,500,000, Borrower's compliance with Section 6.7(c)).;
- (j) a guarantee executed and delivered by Guarantor;
- (k) a pledge agreement executed and delivered by Guarantor pursuant to which Guarantor pledges all of its ownership interest in Borrower and 65% of its ownership interest in Priority Fulfillment Services of Canada, Inc.;
- (l) an officer's certificate of Guarantor with respect to incumbency and resolutions authorizing the execution and delivery of the Loan Documents to which Guarantor is a party;
- (m) subordination agreements duly executed and delivered by each of IBM Credit Corporation, IBM Belgium Financial Services S.A., and Congress Financial Corporation (Southwest);
- (o) true, correct and complete copies of the executed Bond Documents;
- (p) opinion from Borrower's counsel that the execution and delivery of this Agreement, the Bond Documents and the consummation of the transactions contemplated herein and therein do not violate any other contract or agreement of Borrower or Guarantor; and
- (q) such other documents or certificates, and completion of such other matters, as Bank may reasonably deem necessary or appropriate.

3.2 Conditions Precedent to all Credit Extensions. The obligation of Bank to make each Credit Extension, including the initial Credit Extension, is further subject to the following conditions:

- (a) timely receipt by Bank of the Payment/Advance Form as provided in Section 2.1; and
- (b) the representations and warranties contained in Section 5 shall be true and correct in all material respects on and as of the date of such Payment/Advance Form and on the effective date of each Credit Extension as though made at and as of each such date, and no Event of Default shall have occurred and be continuing, or would exist after giving effect to such Credit Extension (provided, however, that those representations and warranties expressly referring to another date shall be true, correct and complete in all material respects as of such date). The making of each Credit Extension shall be deemed to be a representation and warranty by Borrower on the date of such Credit Extension as to the accuracy of the facts referred to in this Section 3.2.

#### 4. CREATION OF SECURITY INTEREST.

4.1 Grant of Security Interest. Borrower grants and pledges to Bank a continuing security interest in the Collateral to secure prompt repayment of any and all Obligations and to secure prompt performance by Borrower of each of its covenants and duties under the Loan Documents. Except as set forth in the Schedule, such security interest constitutes a valid, first priority security interest in the presently existing Collateral, and will constitute a valid, first priority security interest in later-acquired Collateral. Notwithstanding any termination, Bank's Lien on the Collateral shall remain in effect for so long as any Obligations are outstanding.

4.2 Perfection of Security Interest. Borrower authorizes Bank to file at any time financing statements, continuation statements, and amendments thereto that describe the Collateral and to describe the Collateral as all assets of Borrower of the kind pledged hereunder and which contain any other information required by the Code for the sufficiency of filing office acceptance of any financing statement, continuation statement, or amendment, including whether Borrower is an organization, the type of organization and any organizational identification number issued to Borrower, if applicable. Borrower shall from time to time execute and deliver to Bank, at the request of Bank, all Negotiable Collateral and other documents that Bank may reasonably request, in form satisfactory to Bank, to perfect and continue perfected Bank's security interests in the Collateral and in order to fully consummate all of the transactions contemplated under the Loan Documents. Borrower shall have possession of the Collateral, except where expressly otherwise provided in this Agreement or where Bank chooses to perfect its security interest by possession in addition to the filing of a financing statement. Where Collateral is in possession of a third party bailee, Borrower shall take such steps as Bank reasonably requests for Bank to (i) obtain an acknowledgment, in form and substance satisfactory to Bank, of the bailee that the bailee holds such Collateral for the benefit of Bank, (ii) obtain "control" of any Collateral consisting of investment property, deposit accounts, letter-of-credit rights or electronic chattel paper (as such items and the term "control" are defined in Revised Article 9 of the Code) by causing the securities intermediary or depositary institution or issuing bank to execute a control agreement in form and substance satisfactory to Bank. Borrower will not create any chattel paper without placing a legend on the chattel paper acceptable to Bank indicating that Bank has a security interest in the chattel paper.

4.3 Right to Inspect. Bank (through any of its officers, employees, or agents) shall have the right, upon reasonable prior notice, from time to time during Borrower's usual business hours but no more than twice a year (unless an Event of Default has occurred and is continuing), to inspect Borrower's Books and to make copies thereof and to check, test, and appraise the Collateral in order to verify Borrower's financial condition or the amount, condition of, or any other matter relating to, the Collateral.

4.4 Lockbox. Borrower shall notify all account debtors to make payments with respect to its Accounts directly to the lockbox established with Bank (the "Lockbox"). Any payments received by Borrower with respect to its Accounts by wire transfer shall be deposited directly in Borrower's primary deposit accounts held with Bank. Bank shall have exclusive and unrestricted access to the Lockbox. So long as no Event of Default has occurred and is continuing, Bank shall transfer all funds received in the Lockbox in accordance with Borrower's instructions. During the continuation of an Event of Default, all funds received in the Lockbox shall be applied to reduce the Obligations, subject to the terms of Section 2.4.

## 5. REPRESENTATIONS AND WARRANTIES.

Borrower represents and warrants as follows except as set forth in the Schedule:

5.1 Due Organization and Qualification. Borrower and each Subsidiary is a corporation (or limited liability company) duly existing under the laws of its respective Organizational Jurisdiction and qualified and licensed to do business in any state in which the conduct of its business or its ownership of property requires that it be so qualified, except where the failure to do so would not reasonably be expected to cause a Material Adverse Effect.

5.2 Due Authorization; No Conflict. The execution, delivery, and performance of the Loan Documents are within Borrower's powers, have been duly authorized, and are not in conflict with nor constitute a breach of any provision contained in Borrower's Articles of Incorporation or Bylaws, nor will they constitute an event of default under any material agreement by which Borrower is bound. Borrower is not in default under any agreement by which it is bound, except to the extent such default would not reasonably be expected to cause a Material Adverse Effect.

5.3 Collateral. Borrower has rights in or the power to transfer the Collateral, and its title to the Collateral is free and clear of Liens, adverse claims, and restrictions on transfer or pledge except for Permitted Liens. All Collateral is located solely in the Collateral States. The Eligible Accounts are bona fide existing obligations. The property or services giving rise to such Eligible Accounts has been delivered or rendered to the account debtor or its agent for immediate shipment to and unconditional acceptance by the account debtor subject to the audit disputes and other rights of the account debtor arising in the ordinary course of business of Borrower.

Borrower has not received notice of actual or imminent Insolvency Proceeding of any account debtor whose accounts are included in any Borrowing Base Certificate as an Eligible Account. All Inventory is in all material respects of good and merchantable quality, free from all material defects, except for Inventory for which adequate reserves have been made. Except as set forth in the Schedule, no security account or deposit account (excluding the Third Party Deposit Accounts) is maintained or invested with a Person other than Bank or Bank's affiliates.

5.4 Intellectual Property Collateral. Borrower is the sole owner of the Intellectual Property Collateral, except for licenses granted by Borrower to its customers in the ordinary course of business. To the best of Borrower's knowledge, each of the Copyrights, Trademarks and Patents is valid and enforceable, and no part of the Intellectual Property Collateral has been judged invalid or unenforceable, in whole or in part, and no claim has been made to Borrower that any part of the Intellectual Property Collateral violates the rights of any third party except to the extent such claim would not reasonably be expected to cause a Material Adverse Effect. Except as set forth in the Schedule, sublicensing fees received or to be received by Borrower with respect to intellectual property do not give rise to more than 5% of its gross revenue in any given month.

5.5 Name; Location of Chief Executive Office. Except as disclosed in the Schedule, Borrower has not done business under any name other than that specified on the signature page hereof, and its exact legal name is as set forth in the first paragraph of this Agreement. The chief executive office of Borrower is located in its Chief Executive Office.

5.6 Litigation. Except as set forth in the Schedule, there are no actions or proceedings pending by or against Borrower or any Subsidiary before any court or administrative agency in which a likely adverse decision would reasonably be expected to have a Material Adverse Effect, or a material adverse effect on Borrower's interest or Bank's security interest in the Collateral.

5.7 No Material Adverse Change in Financial Statements. All consolidating and consolidated financial statements related to Guarantor, Borrower and any Subsidiary that are delivered by Borrower to Bank fairly present in all material respects Guarantor's and Borrower's consolidating and consolidated financial condition as of the date thereof and Guarantor's and Borrower's consolidating and consolidated results of operations for the period then ended. There has not been a material adverse change in the consolidated financial condition of Guarantor or the financial condition of Borrower since the date of the most recent of such financial statements submitted to Bank, except for ordinary seasonal fluctuations in the ordinary course of business.

5.8 Solvency, Payment of Debts. Borrower is able to pay its debts (including trade debts) as they mature; the fair saleable value of Borrower's assets (including goodwill minus disposition costs) exceeds the fair value of its liabilities; and Borrower is not left with unreasonably small capital after the transactions contemplated by this Agreement.

5.9 Compliance with Laws and Regulations. Borrower and each Subsidiary have met the minimum funding requirements of ERISA with respect to any employee benefit plans subject to ERISA. No event has occurred resulting from Borrower's failure to comply with ERISA that is reasonably likely to result in Borrower's incurring any liability that could have a Material Adverse Effect. Borrower is not an "investment company" or a company "controlled" by an "investment company" within the meaning of the Investment Company Act of 1940. Borrower is not engaged principally, or as one of the important activities, in the business of extending credit for the purpose of purchasing or carrying margin stock (within the meaning of Regulations T and U of the Board of Governors of the Federal Reserve System). Borrower has complied in all material respects with all the provisions of the Federal Fair Labor Standards Act. Borrower is in compliance with all environmental laws, regulations and ordinances except where the failure to comply is not reasonably likely to have a Material Adverse Effect. Borrower has not violated any statutes, laws, ordinances or rules applicable to it, violation of which could have a Material Adverse Effect. Borrower and each Subsidiary have filed or caused to be filed all tax returns required to be filed, and have paid, or have made adequate provision for the payment of, all taxes reflected therein except those being contested in good faith with adequate reserves under GAAP or where the failure to file such returns or pay such taxes would not reasonably be expected to have a Material Adverse Effect.

5.10 Subsidiaries. Borrower does not own any stock, partnership interest or other equity securities of any Person, except for Permitted Investments.



5.11 Government Consents. Borrower and each Subsidiary have obtained all consents, approvals and authorizations of, made all declarations or filings with, and given all notices to, all governmental authorities that are necessary for the continued operation of Borrower's business as currently conducted, except where the failure to do so would not reasonably be expected to cause a Material Adverse Effect.

5.12 Intentionally Omitted.

5.13 Full Disclosure. No representation, warranty or other statement made by Borrower in any certificate or written statement furnished to Bank taken together with all such certificates and written statements furnished to Bank contains any untrue statement of a material fact or omits to state a material fact necessary in order to make the statements contained in such certificates or statements not misleading, it being recognized by Bank that the projections and forecasts provided by Borrower in good faith and based upon reasonable assumptions are not to be viewed as facts and that actual results during the period or periods covered by any such projections and forecasts may differ from the projected or forecasted results.

## 6. AFFIRMATIVE COVENANTS.

Borrower covenants that, until payment in full of all outstanding Obligations, and for so long as Bank may have any commitment to make a Credit Extension hereunder, Borrower shall do all of the following:

6.1 Good Standing and Government Compliance. Borrower shall maintain its and each of its Subsidiaries' corporate existence and good standing in its respective Organizational Jurisdiction, shall maintain qualification and good standing in each jurisdiction in which the failure to so qualify could have a Material Adverse Effect, and shall furnish to Bank the organizational identification number issued to Borrower by the authorities of the state in which Borrower is organized, if applicable. Borrower shall meet, and shall cause each Subsidiary to meet, the minimum funding requirements of ERISA with respect to any employee benefit plans subject to ERISA, except where the failure to meet such requirements would not reasonably be expected to have a Material Adverse Effect. Borrower shall comply in all material respects with all applicable Environmental Laws, and maintain all material permits, licenses and approvals required thereunder where the failure to do so could have a Material Adverse Effect. Borrower shall comply, and shall cause each Subsidiary to comply, with all statutes, laws, ordinances and government rules and regulations to which it is subject, and shall maintain, and shall cause each of its Subsidiaries to maintain, in force all licenses, approvals and agreements, the loss of which or failure to comply with which would reasonably be expected to have a Material Adverse Effect, or a material adverse effect on the Collateral or the priority of Bank's Lien on the Collateral.

6.2 Financial Statements, Reports, Certificates. Borrower shall deliver to Bank:

(a) as soon as available, but in any event within 35 days after the end of each calendar month, a company prepared consolidated and consolidating balance sheet and income statement of Guarantor covering Borrower's operations during such period, in a form reasonably acceptable to Bank and certified by a Responsible Officer;

(b) as soon as available, but in any event within 90 days after the end of Guarantor's fiscal year, audited consolidated and unaudited consolidating financial statements of Guarantor prepared in accordance with GAAP, consistently applied, together with an opinion which is unqualified or otherwise consented to in writing by Bank on such consolidated financial statements of an independent certified public accounting firm reasonably acceptable to Bank;

(c) as soon as available, but in any event within 90 days after the end of BSD's fiscal year, audited consolidated and unaudited consolidating financial statements of BSD prepared in accordance with GAAP, consistently applied, together with an opinion which is unqualified or otherwise consented to in writing by Bank on such consolidated financial statements of an independent certified public accounting firm reasonably acceptable to Bank;

- (d) as soon as available, but in any event within 45 days after the end of Guarantor's fiscal quarter, all reports on Form 10-Q filed by Guarantor with the Securities and Exchange Commission;
- (e) as soon as available, but in any event within 90 days after the end of Guarantor's fiscal year, all reports on Form 10-K filed by Guarantor with the Securities and Exchange Commission;
- (f) if applicable, copies of all other statements, reports and notices sent or made available generally by Borrower or Guarantor to its security holders or to any holders of Subordinated Debt;
- (g) promptly upon receipt of notice thereof, a report of any legal actions pending or threatened against Borrower or any Subsidiary that could result in damages or costs to Borrower or any Subsidiary of \$250,000 or more;
- (h) such budgets, sales projections, operating plans or other financial information generally prepared by Borrower in the ordinary course of business as Bank may reasonably request from time to time;
- (i) within 30 days of the last day of each fiscal quarter, a report signed by Borrower, in form reasonably acceptable to Bank, listing any applications or registrations that Borrower has made or filed in respect of any Patents, Copyrights or Trademarks and the status of any outstanding applications or registrations, as well as any material change in Borrower's Intellectual Property Collateral, including but not limited to any subsequent ownership right of Borrower in or to any Trademark, Patent or Copyright not specified in Exhibits A, B, and C of the Intellectual Property Security Agreement delivered to Bank by Borrower in connection with this Agreement;
- (j) within 30 days after the last day of each month, Borrower shall deliver to Bank a Borrowing Base Certificate signed by a Responsible Officer in substantially the form of Exhibit D hereto, together with aged listings by invoice date of accounts receivable and accounts payable;
- (k) within 35 days after the last day of each month, Borrower shall deliver to Bank with the monthly financial statements a Compliance Certificate signed by a Responsible Officer in substantially the form of Exhibit E hereto;
- (l) on or before January 31 of each year, a preliminary draft of Borrower's financial projections (including income statement and balance sheet) for the following fiscal year;
- (m) on or before February 28 of each year, a copy of Borrower's financial projections (including income statement and balance sheet) for the following fiscal year, as approved by Borrower's Board of Directors;
- (n) as soon as possible and in any event within 3 calendar days after becoming aware of the occurrence or existence of an Event of Default hereunder, a written statement of a Responsible Officer setting forth details of the Event of Default, and the action which Borrower has taken or proposes to take with respect thereto; and
- (o) Bank shall have a right from time to time, upon reasonable prior notice, hereafter to audit Borrower's Accounts and appraise Collateral at Borrower's expense, provided that such audits will be conducted no more often than every 6 months unless an Event of Default has occurred and is continuing.

6.3 Inventory; Returns. Borrower shall keep all Inventory in good and merchantable condition, free from all material defects except for Inventory for which adequate reserves have been made. Returns and allowances, if any, as between Borrower and its account debtors shall be on the same basis and in accordance with the usual customary practices of Borrower, as they exist on the Closing Date. Borrower shall promptly notify Bank of all returns and recoveries and of all disputes and claims involving more than \$100,000.

6.4 Taxes. Borrower shall make, and cause each Subsidiary to make, due and timely payment or deposit of all material federal, state, and local taxes, assessments, or contributions required of it by law, including, but not limited to, those laws concerning income taxes, F.I.C.A., F.U.T.A. and state disability, and will execute and deliver to Bank, on demand, proof satisfactory to Bank indicating that Borrower or a Subsidiary has made such payments or deposits and any appropriate certificates attesting to the payment or deposit thereof; provided that Borrower or a Subsidiary need not make any payment if the amount or validity of such payment is contested in good faith by appropriate proceedings and is reserved against (to the extent required by GAAP) by Borrower.

6.5 Insurance.

(a) Borrower, at its expense, shall keep the Collateral insured against loss or damage by fire, theft, explosion, sprinklers, and all other hazards and risks, and in such amounts, as ordinarily insured against by other owners in similar businesses conducted in the locations where Borrower's business is conducted on the date hereof. Borrower shall also maintain liability and other insurance in amounts and of a type that are customary to businesses similar to Borrower's.

(b) All such policies of insurance shall be in such form, with such companies, and in such amounts as reasonably satisfactory to Bank. All policies of property insurance shall contain a lender's loss payable endorsement, in a form satisfactory to Bank, showing Bank as an additional loss payee, and all liability insurance policies shall show Bank as an additional insured and specify that the insurer must give at least 20 days notice to Bank before canceling its policy for any reason. Upon Bank's request, Borrower shall deliver to Bank certified copies of the policies of insurance and evidence of all premium payments. If no Event of Default has occurred and is continuing, proceeds payable under any casualty policy will, at Borrower's option, be payable to Borrower to replace the property subject to the claim, provided that any such replacement property shall be deemed Collateral in which Bank has been granted a first priority security interest. If an Event of Default has occurred and is continuing, all proceeds payable under any such policy shall, at Bank's option, be payable to Bank to be applied on account of the Obligations.

6.6 Primary Depository. Except for those accounts specified on the Schedule that support existing letters of credit issued at the application of Borrower and the Third Party Deposit Accounts, all primary depository, operating and investment accounts of Borrower shall be maintained with Bank or Bank's Affiliates.

6.7 Financial Covenants. Borrower shall at all times maintain the following financial ratios and covenants, measured as of the last day of each calendar month unless stated otherwise:

(a) Liquidity Ratio. A ratio of Cash (including all Cash held in a sinking fund with Bank for repayment of the Bonds) plus Eligible Accounts to the remainder of (i) all Indebtedness to Bank minus (ii) 65% of the aggregate original acquisition cost of the Equipment purchased by Borrower with Bond proceeds and Equipment Advances of at least 1.25 to 1.00.

(b) Minimum Cash. A balance of Cash at Bank and Cash at Bank's affiliates covered by a control agreement (including all Cash held in a sinking fund with Bank for repayment of the Bonds) of not less than \$1,250,000; provided that in the event the appraisal of Equipment described in Section 3.1(j) reflects an aggregate orderly liquidation value of less than \$3,500,000 (such deficiency, herein called a "Shortfall"), the \$1,250,000 minimum cash requirement shall be automatically increased by the amount of the Shortfall. For example, if the appraisal reflects an aggregate orderly liquidation value of \$3,000,000, Borrower will be required to maintain Cash at Bank and Cash at Bank's affiliates of not less than \$1,750,000.

(c) Tangible Net Worth. A consolidated Tangible Net Worth of Guarantor not less than the greater of (i) \$20,000,000 or (ii) \$2,000,000 plus the amount of Tangible Net Worth of Guarantor required to be maintained pursuant to the terms of the loan documents between Borrower and IBM Belgium Financial Services S.A., Congress Financial Corporation (Southwest) or IBM Credit Corporation, as from time to time amended, modified or restated.

(d) EBITDA. For each month ending during the period beginning December 2004 through and including May 2005, the variance, if negative (but expressed as a positive number), between Borrower's EBITDA for the Applicable Period and (i) for the period ending December 2004, \$1,669,000, and (ii) for each period thereafter, the EBITDA set forth in the Approved Projections for such period shall not exceed the Allowed Variance. Beginning with June 2005 and each month thereafter, the variance, if negative (but expressed as a positive number), between Borrower's EBITDA for the twelve consecutive month period ending on the date of calculation and the EBITDA set forth in the Approved Projections for such twelve consecutive month period shall not exceed \$2,400,000. As used herein, "EBITDA" shall mean, for any period of calculation, Borrower's earnings for such period before interest and taxes plus depreciation, amortization and non-cash stock compensation accruals to the extent deducted in the calculation of such earnings. "Applicable Period" shall mean, as of any date of calculation, the period beginning on June 1, 2004, through and including such date of calculation. "Allowed Variance" means, for any date of calculation, \$200,000 multiplied by the number of months included in the Applicable Period for such date of calculation. "Approved Projections" means for any period of time, the projections for such period that have been approved by Borrower's Board of Directors and delivered to Bank. Borrower shall deliver to Bank (i) a preliminary draft of the projections for the next fiscal year of Borrower by January 31 of each year and (ii) the updated projections approved by Borrower's Board of Directors for the next fiscal year not later than February 28 of each year.

#### 6.8 Registration of Intellectual Property Rights.

(a) Borrower shall register or cause to be registered on an expedited basis (to the extent not already registered) with the United States Patent and Trademark Office or the United States Copyright Office, as the case may be, those registerable intellectual property rights now owned or hereafter developed or acquired by Borrower, to the extent that Borrower, in its reasonable business judgment, deems it appropriate to so protect such intellectual property rights.

(b) Borrower shall promptly give Bank written notice of any applications or registrations of intellectual property rights filed with the United States Patent and Trademark Office, including the date of such filing and the registration or application numbers, if any.

(c) Borrower shall (i) give Bank not less than 30 days prior written notice of the filing of any applications or registrations with the United States Copyright Office, including the title of such intellectual property rights to be registered, as such title will appear on such applications or registrations, and the date such applications or registrations will be filed, and (ii) prior to the filing of any such applications or registrations, shall execute such documents as Bank may reasonably request for Bank to maintain its perfection in such intellectual property rights to be registered by Borrower, and upon the request of Bank, shall file such documents simultaneously with the filing of any such applications or registrations. Upon filing any such applications or registrations with the United States Copyright Office, Borrower shall promptly provide Bank with (i) a copy of such applications or registrations, without the exhibits, if any, thereto, (ii) evidence of the filing of any documents requested by Bank to be filed for Bank to maintain the perfection and priority of its security interest in such intellectual property rights, and (iii) the date of such filing.

(d) Borrower shall execute and deliver such additional instruments and documents from time to time as Bank shall reasonably request to perfect and maintain the priority of Bank's security interest in the Intellectual Property Collateral.

(e) Borrower shall (i) protect, defend and maintain the validity and enforceability of the trade secrets, Trademarks, Patents and Copyrights, (ii) use commercially reasonable efforts to detect infringements of the Trademarks, Patents and Copyrights and promptly advise Bank in writing of material infringements detected and (iii) not allow any material Trademarks, Patents or Copyrights to be abandoned, forfeited or dedicated to the public without the written consent of Bank, which shall not be unreasonably withheld.

(f) Bank may audit Borrower's Intellectual Property Collateral to confirm compliance with this Section 6.8, provided such audit may not occur more often than twice per year, unless an Event of Default has occurred and is continuing. Bank shall have the right, but not the obligation, to take, at Borrower's sole expense,

any actions that Borrower is required under this Section 6.8 to take but which Borrower fails to take, after 15 days' notice to Borrower.

(g) Borrower shall reimburse and indemnify Bank for all reasonable costs and reasonable expenses incurred in the reasonable exercise of its rights under this Section 6.8.

6.9 Chase Lockbox. Borrower shall use its best efforts to obtain a control agreement in favor of Bank that is executed by Chase Bank on the lockbox and related deposit account of Borrower held with Chase Bank.

6.10 Further Assurances. At any time and from time to time Borrower shall execute and deliver such further instruments and take such further action as may reasonably be requested by Bank to effect the purposes of this Agreement.

6.11 Weekly Reporting. During any period of time that the Adjusted Tangible Net Worth of Guarantor is less than \$21,000,000, Borrower shall deliver the information described in Section 6.2(j) on the second Business Day of each calendar week for the immediately preceding calendar week.

## 7. NEGATIVE COVENANTS.

Borrower covenants and agrees that, so long as any credit hereunder shall be available and until the outstanding Obligations are paid in full or for so long as Bank may have any commitment to make any Credit Extensions, Borrower will not do any of the following without Bank's prior written consent, which shall not be unreasonably withheld:

7.1 Dispositions. Convey, sell, lease, license, transfer or otherwise dispose of (collectively, to "Transfer"), or permit any of its Subsidiaries to Transfer, all or any part of its business or property, other than Permitted Transfers.

7.2 Change in Name, Location or Executive Office, Change in Business; Change in Fiscal Year; Change in Control. Change its name, Organizational Jurisdiction, or relocate its chief executive office without 30 days prior written notification to Bank; engage in any business, or permit any of its Subsidiaries to engage in any business, other than or reasonably related or incidental to the businesses currently engaged in by Borrower; change its fiscal year end; have a Change in Control.

7.3 Mergers or Acquisitions. Merge or consolidate, or permit any of its Subsidiaries to merge or consolidate, with or into any other business organization (other than mergers or consolidations of a Subsidiary into another Subsidiary or into Borrower or Guarantor), or acquire, or permit any of its Subsidiaries to acquire, all or substantially all of the capital stock or property of another Person (other than acquisitions by Borrower, Guarantor or a Subsidiary of an existing Subsidiary's capital stock or property) except where (i) such transactions do not in the aggregate exceed \$250,000 and (ii) no Event of Default has occurred, is continuing or would exist after giving effect to the transactions.

7.4 Indebtedness. Create, incur, assume, guarantee or be or remain liable with respect to any Indebtedness, or permit any Subsidiary so to do, other than Permitted Indebtedness, or prepay any Indebtedness or take any actions which impose on Borrower an obligation to prepay any Indebtedness, except Indebtedness to Bank, if either before or after giving effect to such prepayment, an Event of Default has occurred and is continuing.

7.5 Encumbrances. Create, incur, assume or allow any Lien with respect to any of its property, or assign or otherwise convey any right to receive income, including the sale of any Accounts, or permit any of its Subsidiaries so to do, except for Permitted Liens, or covenant to any other Person that Borrower in the future will refrain from creating, incurring, assuming or allowing any Lien with respect to any of Borrower's property.

7.6 Distributions. Pay any dividends or make any other distribution or payment on account of or in redemption, retirement or purchase of any capital stock, except that Subsidiaries may pay dividends and make such distributions or payments to Borrower and Borrower may (i) repurchase the stock of former employees pursuant to stock repurchase agreements as long as an Event of Default does not exist prior to such repurchase or would not exist after giving effect to such repurchase, and (ii) repurchase the stock of former employees pursuant to stock repurchase agreements by the cancellation of indebtedness owed by such former employees to Borrower regardless of whether an Event of Default exists.

7.7 Investments. Directly or indirectly acquire or own, or make any Investment in or to any Person, or permit any of its Subsidiaries so to do, other than Permitted Investments, or maintain or invest any of its securities accounts or deposit accounts with a Person other than Bank or Bank's affiliates (excluding those existing accounts specified in the Schedule and the Third Party Deposit Accounts) unless such Person has entered into a control agreement with Bank, in form and substance satisfactory to Bank, or suffer or permit any Subsidiary (other than Business Supplies Distributors Holdings, LLC and its Subsidiaries with respect to their existing Indebtedness owed to IBM Credit Corporation, IBM Belgium Financial Services S.A. and Congress Financial Corporation (Southwest)) to be a party to, or be bound by, an agreement that restricts such Subsidiary from paying dividends or otherwise distributing property to Borrower.

7.8 Transactions with Affiliates. Directly or indirectly enter into or permit to exist any material transaction with any Affiliate of Borrower except for (a) the transaction management fees charged to Supplies Distributors, Inc. and its Subsidiaries by Borrower and its Subsidiaries, (b) interest expenses on intercompany Indebtedness owed to Borrower or Guarantor, (c) intercompany tax payments, (d) Permitted Investments, (e) Permitted Indebtedness, and (f) transactions that are in the ordinary course of Borrower's business, upon fair and reasonable terms that are no less favorable to Borrower than would be obtained in an arm's length transaction with a non-affiliated Person.

7.9 Subordinated Debt. Make any payment in respect of any Subordinated Debt, or permit any of its Subsidiaries to make any such payment, except in compliance with the terms of such Subordinated Debt, or amend any material provision affecting Bank's rights contained in any documentation relating to the Subordinated Debt without Bank's prior written consent, which consent shall not be unreasonably withheld or delayed.

7.10 Inventory and Equipment. Store the Inventory or the Equipment with a bailee, warehouseman, or similar third party unless the third party has been notified of Bank's security interest and Bank (a) has received an acknowledgment from the third party that it is holding or will hold the Inventory or Equipment for Bank's benefit or (b) is in possession of the warehouse receipt, where negotiable, covering such Inventory or Equipment. Except for Inventory sold in the ordinary course of business and except for such other locations as Bank may approve in writing, Borrower shall keep the Inventory and Equipment only at the location set forth in Section 10 of the Schedule, and such other locations of which Borrower gives Bank prior written notice and as to which Bank files a financing statement where needed to perfect its security interest.

7.11 No Investment Company. Become or be controlled by an "investment company," within the meaning of the Investment Company Act of 1940, or become principally engaged in, or undertake as one of its important activities, the business of extending credit for the purpose of purchasing or carrying margin stock, or use the proceeds of any Credit Extension for such purpose.

7.12 Capital Expenditures. Make capital expenditures in an aggregate amount (including capital expenditures made by Borrower's Subsidiaries) greater than (i) \$4,000,000 (excluding capital expenditures financed with Bond Proceeds and the Equipment Advances) in each of Borrower's fiscal years 2004 and 2005, and (ii) \$3,000,000 in Borrower's fiscal year 2006, and each fiscal year thereafter. As used herein, the term "capital expenditures" does not include (i) any software that is internally developed by Borrower, whether or not Borrower capitalizes the development costs, and (ii) any equipment ordered, but not yet accepted or paid for, by Borrower.

7.13 Outgoing Wires. During any period in which the ratio of Liquidity Ratio set forth in Section 6.7(a) is less than 2.0 to 1.0, Borrower will not wire any funds from its deposit accounts other than wire transfers to the account debtors and freight providers listed on the Schedule, without the prior approval of Bank. It

being understood that as of the end of each fiscal quarter, Borrower may amend or modify the list of account debtors and freight providers set forth on the attached Schedule by written notice to Bank.

## 8. EVENTS OF DEFAULT.

Any one or more of the following events shall constitute an Event of Default by Borrower under this Agreement:

8.1 Payment Default. If Borrower fails to pay any of the Obligations when due;

8.2 Covenant Default.

(a) If Borrower fails to perform any obligation under Section 6.2(j), 6.2(l) or 6.7 or violates any of the covenants contained in Article 7 of this Agreement; or

(b) If Borrower fails or neglects to perform or observe any other material term, provision, condition, covenant contained in this Agreement, in any of the Loan Documents, or in any other present or future agreement between Borrower and Bank and as to any default under such other term, provision, condition or covenant that can be cured, has failed to cure such default within 10 days after Borrower receives notice thereof or any officer of Borrower becomes aware thereof; provided, however, that if the default cannot by its nature be cured within the 10 day period or cannot after diligent attempts by Borrower be cured within such 10 day period, and such default is likely to be cured within a reasonable time, then Borrower shall have an additional reasonable period (which shall not in any case exceed 30 days) to attempt to cure such default, and within such reasonable time period the failure to have cured such default shall not be deemed an Event of Default but no Credit Extensions will be made;

8.3 Defective Perfection. If Bank shall receive at any time following the Closing Date an SOS Report indicating that except for Permitted Liens, Bank's security interest in the Collateral is not prior to all other security interests or Liens of record reflected in the report;

8.4 Material Adverse Change. If there occurs a material adverse change in Borrower's business or financial condition, or if there is a material impairment of the prospect of repayment of any portion of the Obligations or a material impairment of the value or priority of Bank's security interests in the Collateral;

8.5 Attachment. If any material portion of Borrower's assets is attached, seized, subjected to a writ or distress warrant, or is levied upon, or comes into the possession of any trustee, receiver or person acting in a similar capacity and such attachment, seizure, writ or distress warrant or levy has not been removed, discharged or rescinded within 10 days, or if Borrower is enjoined, restrained, or in any way prevented by court order from continuing to conduct all or any material part of its business affairs, or if a judgment or other claim becomes a lien or encumbrance upon any material portion of Borrower's assets, or if a notice of lien, levy, or assessment is filed of record with respect to any of Borrower's assets by the United States Government, or any department, agency, or instrumentality thereof, or by any state, county, municipal, or governmental agency, and the same is not paid within ten days after Borrower receives notice thereof, provided that none of the foregoing shall constitute an Event of Default where such action or event is stayed or an adequate bond has been posted pending a good faith contest by Borrower (provided that no Credit Extensions will be made during such cure period);

8.6 Insolvency. If Borrower becomes insolvent, or if an Insolvency Proceeding is commenced by Borrower, or if an Insolvency Proceeding is commenced against Borrower and is not dismissed or stayed within 45 days (provided that no Credit Extensions will be made prior to the dismissal of such Insolvency Proceeding);

8.7 Other Agreements. If there is a default or other failure to perform in any agreement to which Borrower is a party with a third party or parties resulting in a right by such third party or parties, whether or not exercised, to accelerate the maturity of any Indebtedness in an amount in excess of \$250,000 or that could have a Material Adverse Effect;

8.8 Subordinated Debt. If Borrower makes any payment on account of Subordinated Debt, except to the extent the payment is allowed under any subordination agreement entered into with Bank;

8.9 Judgments. If a judgment or judgments for the payment of money in an amount, individually or in the aggregate, of at least \$500,000 shall be rendered against Borrower and shall remain unsatisfied and unstayed for a period of 10 days (provided that no Credit Extensions will be made prior to the satisfaction or stay of the judgment); or

8.10 Misrepresentations. If any material misrepresentation or material misstatement exists now or hereafter in any warranty or representation set forth herein or in any certificate delivered to Bank by any Responsible Officer pursuant to this Agreement or to induce Bank to enter into this Agreement or any other Loan Document.

8.11 Guaranty. If any guaranty of all or a portion of the Obligations (a "Guaranty") ceases for any reason to be in full force and effect, or any guarantor fails to perform any obligation under any Guaranty or a security agreement securing any Guaranty (collectively, the "Guaranty Documents"), or any event of default occurs under any Guaranty Document or any guarantor revokes or purports to revoke a Guaranty, or any material misrepresentation or material misstatement exists now or hereafter in any warranty or representation set forth in any Guaranty Document or in any certificate delivered to Bank in connection with any Guaranty Document, or if any of the circumstances described in Sections 8.3 through 8.9 occur with respect to Guarantor or any other guarantor.

## 9. BANK'S RIGHTS AND REMEDIES.

9.1 Rights and Remedies. Upon the occurrence and during the continuance of an Event of Default, Bank may, at its election, without notice of its election and without demand, do any one or more of the following, all of which are authorized by Borrower:

(a) Declare all Obligations, whether evidenced by this Agreement, by any of the other Loan Documents, or otherwise, immediately due and payable (provided that upon the occurrence of an Event of Default described in Section 8.6, all Obligations shall become immediately due and payable without any action by Bank);

(b) Demand that Borrower (i) deposit cash with Bank in an amount equal to the amount of any Letters of Credit remaining undrawn, as collateral security for the repayment of any future drawings under such Letters of Credit, and (ii) pay in advance all Letter of Credit fees scheduled to be paid or payable over the remaining term of the Letters of Credit, and Borrower shall promptly deposit and pay such amounts.

(c) Cease advancing money or extending credit to or for the benefit of Borrower under this Agreement or under any other agreement between Borrower and Bank;

(d) Settle or adjust disputes and claims directly with account debtors for amounts, upon terms and in whatever order that Bank reasonably considers advisable;

(e) Make such payments and do such acts as Bank considers necessary or reasonable to protect its security interest in the Collateral. Borrower agrees to assemble the Collateral if Bank so requires, and to make the Collateral available to Bank as Bank may designate. Borrower authorizes Bank to enter the premises where the Collateral is located, to take and maintain possession of the Collateral, or any part of it, and to pay, purchase, contest, or compromise any encumbrance, charge, or lien which in Bank's determination appears to be prior or superior to its security interest and to pay all expenses incurred in connection therewith. With respect to any of Borrower's owned premises, Borrower hereby grants Bank a license to enter into possession of such premises and to occupy the same, without charge, in order to exercise any of Bank's rights or remedies provided herein, at law, in equity, or otherwise;

(f) Set off and apply to the Obligations any and all (i) balances and deposits of Borrower held by Bank, and (ii) indebtedness at any time owing to or for the credit or the account of Borrower held by Bank;



(g) Ship, reclaim, recover, store, finish, maintain, repair, prepare for sale, advertise for sale, and sell (in the manner provided for herein) the Collateral. Bank is hereby granted a license or other right, solely pursuant to the provisions of this Section 9.1, to use, without charge, Borrower's labels, patents, copyrights, rights of use of any name, trade secrets, trade names, trademarks, service marks, and advertising matter, or any property of a similar nature, as it pertains to the Collateral, in completing production of, advertising for sale, and selling any Collateral and, in connection with Bank's exercise of its rights under this Section 9.1, Borrower's rights under all licenses and all franchise agreements shall inure to Bank's benefit;

(h) Sell the Collateral at either a public or private sale, or both, by way of one or more contracts or transactions, for cash or on terms, in such manner and at such places (including Borrower's premises) as Bank determines is commercially reasonable, and apply any proceeds to the Obligations in whatever manner or order Bank deems appropriate. Bank may sell the Collateral without giving any warranties as to the Collateral. Bank may specifically disclaim any warranties of title or the like. This procedure will not be considered adversely to affect the commercial reasonableness of any sale of the Collateral. If Bank sells any of the Collateral upon credit, Borrower will be credited only with payments actually made by the purchaser, received by Bank, and applied to the indebtedness of the purchaser. If the purchaser fails to pay for the Collateral, Bank may resell the Collateral and Borrower shall be credited with the proceeds of the sale;

(i) Bank may credit bid and purchase at any public sale;

(j) Apply for the appointment of a receiver, trustee, liquidator or conservator of the Collateral, without notice and without regard to the adequacy of the security for the Obligations and without regard to the solvency of Borrower, any guarantor or any other Person liable for any of the Obligations; and

(k) Any deficiency that exists after disposition of the Collateral as provided above will be paid immediately by Borrower.

Bank may comply with any applicable state or federal law requirements in connection with a disposition of the Collateral and compliance will not be considered adversely to affect the commercial reasonableness of any sale of the Collateral.

9.2 Power of Attorney. Effective only upon the occurrence and during the continuance of an Event of Default, Borrower hereby irrevocably appoints Bank (and any of Bank's designated officers, or employees) as Borrower's true and lawful attorney to: (a) send requests for verification of Accounts or notify account debtors of Bank's security interest in the Accounts; (b) endorse Borrower's name on any checks or other forms of payment or security that may come into Bank's possession; (c) sign Borrower's name on any invoice or bill of lading relating to any Account, drafts against account debtors, schedules and assignments of Accounts, verifications of Accounts, and notices to account debtors; (d) dispose of any Collateral; (e) make, settle, and adjust all claims under and decisions with respect to Borrower's policies of insurance; (f) settle and adjust disputes and claims respecting the accounts directly with account debtors, for amounts and upon terms which Bank determines to be reasonable; (g) to modify, in its sole discretion, any intellectual property security agreement entered into between Borrower and Bank without first obtaining Borrower's approval of or signature to such modification by amending Exhibits A, B, and C, thereof, as appropriate, to include reference to any right, title or interest in any Copyrights, Patents or Trademarks acquired by Borrower after the execution hereof or to delete any reference to any right, title or interest in any Copyrights, Patents or Trademarks in which Borrower no longer has or claims to have any right, title or interest; (h) to file, in its sole discretion, one or more financing or continuation statements and amendments thereto, relative to any of the Collateral without the signature of Borrower where permitted by law; and (i) to transfer the Intellectual Property Collateral into the name of Bank or a third party to the extent permitted under the California Uniform Commercial Code; provided Bank may exercise such power of attorney to sign the name of Borrower on any of the documents described in clauses (g), (h) and (i) above regardless of whether an Event of Default has occurred. The appointment of Bank as Borrower's attorney in fact, and each and every one of Bank's rights and powers, being coupled with an interest, is irrevocable until all of the Obligations have been fully repaid and performed and Bank's obligation to provide advances hereunder is terminated.

9.3 Accounts Collection. At any time after the occurrence and during the continuation of an Event of Default, Bank may notify any Person owing funds to Borrower of Bank's security interest in such funds and

verify the amount of such Account. Borrower shall collect all amounts owing to Borrower for Bank, receive in trust all payments as Bank's trustee, and immediately deliver such payments to Bank in their original form as received from the account debtor, with proper endorsements for deposit.

9.4 Bank Expenses. If Borrower fails to pay any amounts or furnish any required proof of payment due to third persons or entities, as required under the terms of this Agreement, then Bank may do any or all of the following after reasonable notice to Borrower: (a) make payment of the same or any part thereof; (b) set up such reserves under the Revolving Facility as Bank deems necessary to protect Bank from the exposure created by such failure; or (c) obtain and maintain insurance policies of the type discussed in Section 6.5 of this Agreement, and take any action with respect to such policies as Bank deems prudent. Any amounts so paid or deposited by Bank shall constitute Bank Expenses, shall be immediately due and payable, and shall bear interest at the then applicable rate hereinabove provided, and shall be secured by the Collateral. Any payments made by Bank shall not constitute an agreement by Bank to make similar payments in the future or a waiver by Bank of any Event of Default under this Agreement.

9.5 Bank's Liability for Collateral. Bank has no obligation to clean up or otherwise prepare the Collateral for sale. All risk of loss, damage or destruction of the Collateral shall be borne by Borrower.

9.6 No Obligation to Pursue Others. Bank has no obligation to attempt to satisfy the Obligations by collecting them from any other person liable for them and Bank may release, modify or waive any collateral provided by any other Person to secure any of the Obligations, all without affecting Bank's rights against Borrower. Borrower waives any right it may have to require Bank to pursue any other Person for any of the Obligations.

9.7 Remedies Cumulative. Bank's rights and remedies under this Agreement, the Loan Documents, and all other agreements shall be cumulative. Bank shall have all other rights and remedies not inconsistent herewith as provided under the Code, by law, or in equity. No exercise by Bank of one right or remedy shall be deemed an election, and no waiver by Bank of any Event of Default on Borrower's part shall be deemed a continuing waiver. No delay by Bank shall constitute a waiver, election, or acquiescence by it. No waiver by Bank shall be effective unless made in a written document signed on behalf of Bank and then shall be effective only in the specific instance and for the specific purpose for which it was given. Borrower expressly agrees that this Section 9.7 may not be waived or modified by Bank by course of performance, conduct, estoppel or otherwise.

9.8 Demand; Protest. Borrower waives demand, protest, notice of protest, notice of default or dishonor, notice of payment and nonpayment, notice of any default, nonpayment at maturity, release, compromise, settlement, extension, or renewal of accounts, documents, instruments, chattel paper, and guarantees at any time held by Bank on which Borrower may in any way be liable.

## 10. NOTICES.

Unless otherwise provided in this Agreement, all notices or demands by any party relating to this Agreement or any other agreement entered into in connection herewith shall be in writing and (except for financial statements and other informational documents which may be sent by first-class mail, postage prepaid) shall be personally delivered or sent by a recognized overnight delivery service, certified mail, postage prepaid, return receipt requested, or by telefacsimile to Borrower or to Bank, as the case may be, at its addresses set forth below:

If to Borrower:	Priority Fulfillment Services, Inc. 500 N. Central Expressway, 5th Floor Plano, Texas 75074 Attn: Thomas J. Madden FAX: (972) 633-3952
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If to Bank:	Comerica Bank 2321 Rosecrans Ave., Suite 5000 El Segundo, CA 90245 Attn: Manager
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with a copy to:

Comerica Bank  
801 E. Campbell Road, Suite 142  
Richardson, Texas 75081  
Attn: Stu Bell  
FAX: (214) 570-7979

The parties hereto may change the address at which they are to receive notices hereunder, by notice in writing in the foregoing manner given to the other.

**11. CHOICE OF LAW AND VENUE; JURY TRIAL WAIVER.** This Agreement shall be governed by, and construed in accordance with, the internal laws of the State of California, without regard to principles of conflicts of law. Each of Borrower and Bank hereby submits to the exclusive jurisdiction of the state and Federal courts located in the County of Santa Clara, State of California. **BANK AND BORROWER EACH ACKNOWLEDGE THAT THE RIGHT TO TRIAL BY JURY IS A CONSTITUTIONAL ONE, BUT THAT IT MAY BE WAIVED. EACH OF THEM, AFTER CONSULTING OR HAVING HAD THE OPPORTUNITY TO CONSULT, WITH COUNSEL OF THEIR CHOICE, KNOWINGLY, VOLUNTARILY AND INTENTIONALLY WAIVES ANY RIGHT ANY OF THEM MAY HAVE TO A TRIAL BY JURY IN ANY LITIGATION BASED UPON OR ARISING OUT OF THIS AGREEMENT OR ANY RELATED INSTRUMENT OR LOAN DOCUMENT OR ANY OF THE TRANSACTIONS CONTEMPLATED BY THIS AGREEMENT OR ANY COURSE OF CONDUCT, DEALING, STATEMENTS (WHETHER ORAL OR WRITTEN), OR ACTION OF ANY OF THEM. THESE PROVISIONS SHALL NOT BE DEEMED TO HAVE BEEN MODIFIED IN ANY RESPECT OR RELINQUISHED BY BANK OR BORROWER, EXCEPT BY A WRITTEN INSTRUMENT EXECUTED BY EACH OF THEM.**

**12. REFERENCE PROVISION.** If and only if the jury trial waiver set forth in Section 11 of this Agreement is invalidated for any reason by a court of law, statute or otherwise, the reference provisions set forth below shall be substituted in place of the jury trial waiver. So long as the jury trial waiver remains valid, the reference provisions set forth in this Section shall be inapplicable.

a. Each controversy, dispute or claim (each, a "Claim") between the parties arising out of or relating to this Agreement, any security agreement executed by Borrower in favor of Bank, any note executed by Borrower in favor of Bank or any other document, instrument or agreement executed by Borrower with or in favor of Bank (collectively in this Section, the "Loan Documents"), other than (i) all matters in connection with nonjudicial foreclosure of security interests in real or personal property; or (ii) the appointment of a receiver or the exercise of other provisional remedies (any of which may be initiated pursuant to applicable law) that are not settled in writing within fifteen (15) days after the date on which a party subject to the Loan Documents gives written notice to all other parties that a Claim exists (the "Claim Date") shall be resolved by a reference proceeding in California in accordance with the provisions of Section 638 et seq. of the California Code of Civil Procedure, or their successor sections ("CCP"), which shall constitute the exclusive remedy for the resolution of any Claim concerning the Loan Documents, including whether such Claim is subject to the reference proceeding. Except as set forth in this section, the parties waive the right to initiate legal proceedings against each other concerning each such Claim. Venue for these proceedings shall be in the Superior Court in the County where the real property, if any, is located or in a County where venue is otherwise appropriate under state law (the "Court"). By mutual agreement, the parties shall select a retired Judge of the Court to serve as referee, and if they cannot so agree within fifteen (15) days after the Claim Date, the Presiding Judge of the Court (or his or her representative) shall promptly select the referee. A request for appointment of a referee may be heard on an ex parte or expedited basis. The referee shall be appointed to sit as a temporary judge, with all the powers for a temporary judge, as authorized by law, and upon selection should take and subscribe to the oath of office as provided for in Rule 244 of the California Rules of Court (or any subsequently enacted Rule). Each party shall have one peremptory challenge pursuant to CCP Section 170.6. Upon being selected, the referee shall (a) be requested to set the matter for a status and trial-setting conference within fifteen (15) days after the date of selection and (b) if practicable, try any and all issues of law or fact and report a statement of decision upon them within ninety (90) days of the date of selection. The referee will have power to expand or limit the amount of discovery a party may employ. Any decision rendered by the referee will be final, binding and conclusive, and judgment shall be entered pursuant to CCP Section 644 in any court in the State of

California having jurisdiction. The parties shall complete all discovery no later than fifteen (15) days before the first trial date established by the referee. The referee may extend such period in the event of a party's refusal to provide requested discovery for any reason whatsoever, including, without limitation, legal objections raised to such discovery or unavailability of a witness due to absence or illness. No party shall be entitled to "priority" in conducting discovery. Either party may take depositions upon seven (7) days written notice, and shall respond to requests for production or inspection of documents within ten (10) days after service. All disputes relating to discovery which cannot be resolved by the parties shall be submitted to the referee whose decision shall be final and binding upon the parties. Pending appointment of the referee as provided herein, the Superior Court is empowered to issue temporary and/or provisional remedies, as appropriate.

b. Except as expressly set forth herein, the referee shall determine the manner in which the reference proceeding is conducted including the time and place of all hearings, the order of presentation of evidence, and all other questions that arise with respect to the course of the reference proceeding. Except for trial, all proceedings and hearings conducted before the referee shall be conducted without a court reporter unless a party requests a court reporter. The party making such a request shall have the obligation to arrange for and pay for the court reporter. Subject to the referee's power to award costs to the prevailing party, the parties shall equally bear the costs of the court reporter at the trial and the referee's expenses.

c. The referee shall determine all issues in accordance with existing California case and statutory law. California rules of evidence applicable to proceedings at law will apply to the reference proceeding. The referee shall be empowered to enter equitable as well as legal relief, to provide all temporary and/or provisional remedies and to enter equitable orders that shall be binding upon the parties. At the close of the reference proceeding, the referee shall issue a single judgment at disposing of all the claims of the parties that are the subject of the reference. The parties reserve the right (i) to contest or appeal from the final judgment or any appealable order or appealable judgment entered by the referee and (ii) to obtain findings of fact, conclusions of laws, a written statement of decision, and (iii) to move for a new trial or a different judgment, which new trial, if granted, shall be a reference proceeding under this provision.

d. If the enabling legislation which provides for appointment of a referee is repealed (and no successor statute is enacted), any dispute between the parties that would otherwise be determined by the reference procedure herein described will be resolved and determined by arbitration conducted by a retired judge of the Court, in accordance with the California Arbitration Act  
Section 1280 through Section 1294.2 of the CCP as amended from time to time. The limitations with respect to discovery as set forth in this Section shall apply to any such arbitration proceeding.

### 13. GENERAL PROVISIONS.

13.1 Successors and Assigns. This Agreement shall bind and inure to the benefit of the respective successors and permitted assigns of each of the parties and shall bind all persons who become bound as a debtor to this Agreement; provided, however, that neither this Agreement nor any rights hereunder may be assigned by Borrower without Bank's prior written consent, which consent may be granted or withheld in Bank's sole discretion. Bank shall have the right without the consent of or notice to Borrower to sell, transfer, negotiate, or grant participation in all or any part of, or any interest in, Bank's obligations, rights and benefits hereunder.

13.2 Indemnification. Borrower shall defend, indemnify and hold harmless Bank and its officers, employees, and agents against: (a) all obligations, demands, claims, and liabilities claimed or asserted by any other party in connection with the transactions contemplated by this Agreement, except for obligations, demands, claims and liabilities caused by Bank's gross negligence or willful misconduct; and (b) all losses or Bank Expenses in any way suffered, incurred, or paid by Bank, its officers, employees and agents as a result of or in any way arising out of, following, or consequential to transactions between Bank and Borrower whether under this Agreement, or otherwise (including without limitation reasonable attorneys fees and expenses), INCLUDING ANY OBLIGATIONS, DEMANDS, CLAIMS, LIABILITIES AND LOSSES RESULTING FROM BANK'S OWN NEGLIGENCE OR ARISING OUT OF ANY CLAIM OR THEORY OF STRICT LIABILITY, except for losses caused by Bank's gross negligence or willful misconduct.

13.3 Time of Essence. Time is of the essence for the performance of all obligations set forth in this Agreement.

13.4 Severability of Provisions. Each provision of this Agreement shall be severable from every other provision of this Agreement for the purpose of determining the legal enforceability of any specific provision.

13.5 Amendments in Writing, Integration. All amendments to or terminations of this Agreement must be in writing. All prior agreements, understandings, representations, warranties, and negotiations between the parties hereto with respect to the subject matter of this Agreement, if any, are merged into this Agreement and the Loan Documents.

13.6 Counterparts. This Agreement may be executed in any number of counterparts and by different parties on separate counterparts, each of which, when executed and delivered, shall be deemed to be an original, and all of which, when taken together, shall constitute but one and the same Agreement.

13.7 Survival. All covenants, representations and warranties made in this Agreement shall continue in full force and effect so long as any Obligations remain outstanding. The obligations of Borrower to indemnify Bank with respect to the expenses, damages, losses, costs and liabilities described in Section 13.2 shall survive until all applicable statute of limitations periods with respect to actions that may be brought against Bank have run.

13.8 Confidentiality. In handling any confidential information, Bank and all employees and agents of Bank shall exercise the same degree of care that Bank exercises with respect to its own proprietary information of the same types to maintain the confidentiality of any non-public information thereby received or received pursuant to this Agreement except that disclosure of such information may be made (i) to the subsidiaries or affiliates of Bank in connection with their present or prospective business relations with Borrower, (ii) to prospective transferees or purchasers of any interest in the Loans, provided that they have entered into a comparable confidentiality agreement in favor of Borrower and have delivered a copy to Borrower, (iii) as required by law, regulations, rule or order, subpoena, judicial order or similar order, (iv) as may be required in connection with the examination, audit or similar investigation of Bank and (v) as Bank may determine in connection with the enforcement of any remedies hereunder. Confidential information hereunder shall not include information that either: (a) is in the public domain or in the knowledge or possession of Bank when disclosed to Bank, or becomes part of the public domain after disclosure to Bank through no fault of Bank; or (b) is disclosed to Bank by a third party, provided Bank does not have actual knowledge that such third party is prohibited from disclosing such information.

13.9 Restatement. This Agreement restates, amends and continues in its entirety that certain Loan and Security Agreement dated as of March 28, 2003 (as heretofore amended, the "Original Agreement"), among Borrower, Priority Fulfillment Services of Canada, Inc. ("PFS Canada"), and Bank, and all of the terms and provisions hereof shall supersede the terms and provisions thereof. This Agreement renews, extends, and continues all liens, rights and security interests on any property of Borrower existing by virtue of the Original Agreement, but the terms and provisions and conditions of such liens, rights, and security interests shall hereafter be governed in all respects by this Agreement. Inasmuch as Borrower and PFS Canada were jointly and severally liable for all obligations under the Original Agreement, Borrower hereby irrevocably and unconditionally assumes and promises to perform all duties, responsibilities and obligations of PFS Canada arising out of or pursuant to the Original Agreement or any other Loan Document (as defined in the Original Agreement). PFS Canada is hereby released from all obligations and liabilities to Bank under the Original Agreement.

THIS WRITTEN AGREEMENT AND THE OTHER LOAN DOCUMENTS REPRESENT THE FINAL AGREEMENT BETWEEN THE PARTIES AND MAY NOT BE CONTRADICTED BY EVIDENCE OF PRIOR, CONTEMPORANEOUS, OR SUBSEQUENT ORAL AGREEMENTS OF THE PARTIES.

**THERE ARE NO UNWRITTEN ORAL AGREEMENTS BETWEEN THE PARTIES.**

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed as of the date first above written.

**PRIORITY FULFILLMENT SERVICES, INC.**

By:\_\_\_\_\_

Title:\_\_\_\_\_

**COMERICA BANK**

By:\_\_\_\_\_

Title:\_\_\_\_\_

## EXHIBIT A

### DEFINITIONS

"Accounts" means all presently existing and hereafter arising accounts, contract rights, and all other forms of obligations owing to Borrower arising out of the sale or lease of goods (including, without limitation, the licensing of software and other technology) or the rendering of services by Borrower and any and all credit insurance, guaranties, and other security therefor, as well as all merchandise returned to or reclaimed by Borrower and Borrower's Books relating to any of the foregoing.

"Advance" or "Advances" means a cash advance or cash advances under the Revolving Facility.

"Affiliate" means, with respect to any Person, any Person that owns or controls directly or indirectly such Person, any Person that controls or is controlled by or is under common control with such Person, and each of such Person's senior executive officers, directors, and partners.

"Bank Expenses" means all reasonable costs or expenses (including reasonable attorneys' fees and expenses, whether generated in-house or by outside counsel) incurred in connection with the preparation, negotiation, administration, and enforcement of the Loan Documents; reasonable Collateral audit fees; and Bank's reasonable attorneys' fees and expenses (whether generated in-house or by outside counsel) incurred in amending, enforcing or defending the Loan Documents (including fees and expenses of appeal), incurred before, during and after an Insolvency Proceeding, whether or not suit is brought.

"Bonds" means the \$5,000,000 Mississippi Business Finance Corporation Taxable Variable Rate Demand Limited Obligation Revenue Bonds, Series 2004 (Priority Fulfillment Services, Inc. Project).

"Bond Documents" means all documents, instruments and agreements executed by Borrower in connection with the issuance of the Bonds.

"Borrower's Books" means all of Borrower's books and records including: ledgers; records concerning Borrower's assets or liabilities, the Collateral, business operations or financial condition; and all computer programs, or tape files, and the equipment, containing such information.

"Borrowing Base" means an amount equal to 80% of Eligible Accounts, as determined by Bank with reference to the most recent Borrowing Base Certificate delivered by Borrower.

"BSD" means Business Supplies Distributors Holdings, LLC, a Delaware limited liability company.

"Business Day" means any day that is not a Saturday, Sunday, or other day on which banks in the State of California are authorized or required to close.

"Cash" means unrestricted cash and cash equivalents.

"Change in Control" shall mean a transaction in which any "person" or "group" (within the meaning of Section 13(d) and 14(d)(2) of the Securities Exchange Act of 1934) becomes the "beneficial owner" (as defined in Rule 13d-3 under the Securities Exchange Act of 1934), directly or indirectly, of a sufficient number of shares of all classes of stock then outstanding of Borrower ordinarily entitled to vote in the election of directors, empowering such "person" or "group" to elect a majority of the Board of Directors of Borrower, who did not have such power before such transaction.

"Chief Executive Office" means 500 North Central Expressway, 5th Floor, Plano, Texas 75074, where Borrower's chief executive office is located.

"Closing Date" means the date of this Agreement.

"Code" means the California Uniform Commercial Code as amended or supplemented from time to time.

"Collateral" means the property described on Exhibit B attached hereto and all Negotiable Collateral and Intellectual Property Collateral to the extent not described on Exhibit B, except to the extent any such property (i) is nonassignable by its terms without the consent of the licensor thereof or another party (but only to the extent such prohibition on transfer is enforceable under applicable law, including, without limitation, Sections 9406 and 9408 of the Code), or (ii) the granting of a security interest therein is contrary to applicable law, provided that upon the cessation of any such restriction or prohibition, such property shall automatically become part of the Collateral.

"Collateral State" means the state or states where the Collateral is located, which are Texas, Tennessee, and Mississippi.

"Committed Revolving Line" means a Credit Extension of up to \$5,000,000 (inclusive of any amounts outstanding under the Letter of Credit Sublimit).

"Contingent Obligation" means, as applied to any Person (other than as between Borrowers, Guarantor or any Subsidiary), any direct or indirect liability, contingent or otherwise, of that Person with respect to (i) any indebtedness, lease, dividend, letter of credit or other obligation of another, including, without limitation, any such obligation directly or indirectly guaranteed, endorsed, co-made or discounted or sold with recourse by that Person, or in respect of which that Person is otherwise directly or indirectly liable; (ii) any obligations with respect to undrawn letters of credit issued for the account of that Person; and (iii) all obligations arising under any interest rate, currency or commodity swap agreement, interest rate cap agreement, interest rate collar agreement, or other agreement or arrangement designated to protect a Person against fluctuation in interest rates, currency exchange rates or commodity prices; provided, however, that the term "Contingent Obligation" shall not include endorsements for collection or deposit in the ordinary course of business. The amount of any Contingent Obligation shall be deemed to be an amount equal to the stated or determined amount of the primary obligation in respect of which such Contingent Obligation is made or, if not stated or determinable, the maximum reasonably anticipated liability in respect thereof as determined by such Person in good faith; provided, however, that such amount shall not in any event exceed the maximum amount of the obligations under the guarantee or other support arrangement.

"Copyrights" means any and all copyright rights, copyright applications, copyright registrations and like protections in each work or authorship and derivative work thereof, whether published or unpublished and whether or not the same also constitutes a trade secret, now or hereafter existing, created, acquired or held.

"Credit Extension" means each Advance, Equipment Advance, the Equipment Term Loan, or any other extension of credit by Bank to or for the benefit of Borrower hereunder.

"Designated Account Debtor" means that certain account debtor named as the "Designated Account Debtor" by Borrower and Bank in a separate letter agreement of even date herewith, as from time to time amended or modified.

"Eligible Accounts" means those Accounts that arise in the ordinary course of Borrower's business that comply with all of Borrower's representations and warranties to Bank set forth in Section 5.3; provided, that Bank may change the standards of eligibility by giving Borrower 30 days prior written notice. Unless otherwise agreed to by Bank, Eligible Accounts shall not include the following (all references to percentages shall mean in dollar amount):

- (a) Accounts that the account debtor has failed to pay in full within 90 days of invoice date;
- (b) Accounts with respect to an account debtor, 25% of whose Accounts the account debtor has failed to pay within 90 days of invoice date;
- (c) Accounts with respect to which the account debtor is an officer, employee, or agent of Borrower;
- (d) Accounts arising from the sale of goods by Borrower and with respect to which such goods are placed on consignment, guaranteed sale, sale or return, sale on approval, bill and hold, demo or promotional, or other terms by reason of which the payment by the account debtor may be conditional;



- (e) Accounts with respect to which the account debtor is an Affiliate of Borrower;
- (f) Accounts with respect to which the account debtor does not have its principal place of business in the United States, except for Eligible Foreign Accounts;
- (g) Accounts with respect to which the account debtor is the United States or any department, agency, or instrumentality of the United States, except for Accounts of the United States if the payee has assigned its payment rights to Bank and the assignment has been acknowledged under the Assignment of Claims Act of 1940 (31 U.S.C. 3727);
- (h) Accounts with respect to which Borrower is liable to the account debtor for goods sold or services rendered by the account debtor to Borrower, but only to the extent of any amounts owing to the account debtor against amounts owed to Borrower (excluding amounts owed to account debtors for money received in Third Party Deposit Accounts and money received or to be received in settlement of credit card account receivables of Borrower's account debtors);
- (i) Accounts with respect to an account debtor (other than IBM and the Designated Account Debtor), including Subsidiaries and Affiliates, whose total obligations to Borrower exceed 25% of all Accounts, to the extent such obligations exceed the aforementioned percentage, except as approved in writing by Bank;
- (j) Accounts with respect to which IBM is the account debtor, to the extent that its total obligations to Borrower exceed 40% of all Accounts, except as approved in writing by Bank;
- (k) Accounts with respect to which the Designated Account Debtor is the account debtor, to the extent that its total obligations to Borrower exceed 35% of all Accounts, except as approved in writing by Bank;
- (l) Accounts with respect to which the account debtor disputes liability or makes any claim with respect thereto as to which Bank believes, in its sole discretion, that there may be a basis for dispute (but only to the extent of the amount subject to such dispute or claim), or is subject to any Insolvency Proceeding, or becomes insolvent, or goes out of business;
- (m) Credit card Accounts; and
- (n) Accounts the collection of which Bank reasonably determines after inquiry and consultation with Borrower to be doubtful.

"Eligible Foreign Accounts" means Accounts with respect to which the account debtor does not have its principal place of business in the United States and that are (i) supported by one or more letters of credit in an amount and of a tenor, and issued by a financial institution, acceptable to Bank, (ii) insured by EXIM Bank, (iii) generated by an account debtor with its principal place of business in Canada, provided that the Bank has perfected its security interest in the appropriate Canadian province, or (iv) approved by Bank on a case-by-case basis.

"Environmental Laws" means all laws, rules, regulations, orders and the like issued by any federal state, local foreign or other governmental or quasi-governmental authority or any agency pertaining to the environment or to any hazardous materials or wastes, toxic substances, flammable, explosive or radioactive materials, asbestos or other similar materials.

"Equipment" means all present and future machinery, equipment, tenant improvements, furniture, fixtures, vehicles, tools, parts and attachments in which Borrower has any interest.

"Equipment Advance" has the meaning set forth in Section 2.1(c).

"Equipment Term Loan" has the meaning assigned in Section 2.1(e).

"ERISA" means the Employee Retirement Income Security Act of 1974, as amended, and the regulations thereunder.

"Event of Default" has the meaning assigned in Article 8.

"GAAP" means generally accepted accounting principles, consistently applied, as in effect from time to time.

"Guarantor" means PFSweb, Inc., a Delaware corporation.

"Indebtedness" means (a) all indebtedness for borrowed money or the deferred purchase price of property or services, including without limitation reimbursement and other obligations with respect to surety bonds and letters of credit, (b) all obligations evidenced by notes, bonds, debentures or similar instruments, (c) all capital lease obligations, and (d) all Contingent Obligations.

"Insolvency Proceeding" means any proceeding commenced by or against any Person or entity under any provision of the United States Bankruptcy Code, as amended, or under any other bankruptcy or insolvency law, including assignments for the benefit of creditors, formal or informal moratoria, compositions, extension generally with its creditors, or proceedings seeking reorganization, arrangement, or other relief.

"Intellectual Property Collateral" means all of Borrower's right, title, and interest in and to the following to the extent freely assignable:

(a) Copyrights, Trademarks and Patents;

(b) Any and all trade secrets, and any and all intellectual property rights in computer software and computer software products now or hereafter existing, created, acquired or held;

(c) Any and all design rights which may be available to Borrower now or hereafter existing, created, acquired or held;

(d) Any and all claims for damages by way of past, present and future infringement of any of the rights included above, with the right, but not the obligation, to sue for and collect such damages for said use or infringement of the intellectual property rights identified above;

(e) All licenses or other rights to use any of the Copyrights, Patents or Trademarks, and all license fees and royalties arising from such use to the extent permitted by such license or rights;

(f) All amendments, renewals and extensions of any of the Copyrights, Trademarks or Patents; and

(g) All proceeds and products of the foregoing, including without limitation all payments under insurance or any indemnity or warranty payable in respect of any of the foregoing.

"Inventory" means all present and future inventory in which Borrower has any interest, including merchandise, raw materials, parts, supplies, packing and shipping materials, work in process and finished products intended for sale or lease or to be furnished under a contract of service, of every kind and description now or at any time hereafter owned by or in the custody or possession, actual or constructive, of Borrower, including such inventory as is temporarily out of its custody or possession or in transit and including any returns upon any accounts or other proceeds, including insurance proceeds, resulting from the sale or disposition of any of the foregoing and any documents of title representing any of the above, and Borrower's Books relating to any of the foregoing. Inventory does not include any of the foregoing which is now or hereafter held by, or in the possession of, Borrower for or on behalf of its customers.

"Investment" means any beneficial ownership of (including stock, partnership or limited liability company interest or other securities) any Person, or any loan, advance or capital contribution to any Person.

"IRC" means the Internal Revenue Code of 1986, as amended, and the regulations thereunder.

"Letter of Credit" means a commercial or standby letter of credit or similar undertaking issued by Bank at Borrower's request in accordance with Section 2.1(b)(iii).

"Letter of Credit Sublimit" means a sublimit for Letters of Credit under the Committed Revolving Line not to exceed \$2,500,000.

"Lien" means any mortgage, lien, deed of trust, charge, pledge, security interest or other encumbrance.

"Loan Documents" means, collectively, this Agreement, any note or notes executed by Borrower, and any other document, instrument or agreement entered into between Borrower and Bank in connection with this Agreement, all as amended or extended from time to time.

"Material Adverse Effect" means a material adverse effect on (i) the business operations or condition (financial or otherwise) of Borrower and its Subsidiaries taken as a whole or (ii) the ability of Borrower to repay the Obligations or otherwise perform its obligations under the Loan Documents.

"Maximum Equipment Line Availability" means \$1,000,000.

"Negotiable Collateral" means all of Borrower's present and future letters of credit of which it is a beneficiary, drafts, instruments (including promissory notes), securities, documents of title, and chattel paper, and Borrower's Books relating to any of the foregoing.

"Obligations" means all debt, principal, interest, Bank Expenses and other amounts owed to Bank by Borrower pursuant to this Agreement or any other agreement, whether absolute or contingent, due or to become due, now existing or hereafter arising, including any interest that accrues after the commencement of an Insolvency Proceeding and including any debt, liability, or obligation owing from Borrower to others that Bank may have obtained by assignment or otherwise.

"Organizational Jurisdiction" means (a) with respect to Borrower, Delaware, the state under whose laws Borrower is organized, and (b) with respect to each Subsidiary, the jurisdiction indicated opposite such Subsidiary's name on the Schedule.

"Patents" means all patents, patent applications and like protections including without limitation improvements, divisions, continuations, renewals, reissues, extensions and continuations-in-part of the same.

"Periodic Payments" means all installments or similar recurring payments that Borrower may now or hereafter become obligated to pay to Bank pursuant to the terms and provisions of any instrument, or agreement now or hereafter in existence between Borrower and Bank.

"Permitted Indebtedness" means (without duplication):

(a) Indebtedness of Borrower in favor of Bank arising under this Agreement or any other Loan Document;

(b) Indebtedness existing on the Closing Date and disclosed in the Schedule;

(c) Indebtedness not to exceed (i) \$4,000,000 in the aggregate in each of Borrower's fiscal years 2004 and 2005 and (ii) \$3,000,000 in the aggregate in Borrower's fiscal year 2006 and in each fiscal year thereafter, secured by a lien described in clause (c) of the defined term "Permitted Liens," provided such Indebtedness does not exceed the lesser of the cost or fair market value of the equipment financed with such Indebtedness;

(d) Subordinated Debt and the Indebtedness described in clause (h) of Permitted Investments (but without duplication thereof);

(e) Indebtedness to or for the benefit of trade creditors incurred in the ordinary course of business

(f) Indebtedness arising under any interest rate, currency or commodity swap agreement, interest rate cap agreement, interest rate collar agreement or other agreement or arrangement designated to protect a Person against fluctuation in interest rates, currency exchange rates or commodity prices, provided that such agreements and arrangements are with counterparties and on terms reasonably satisfactory to Bank;

(g) Indebtedness of Borrower under (i) the Reimbursement Agreement; (ii) that certain Loan Agreement dated as of November 1, 2004, between Borrower and the Mississippi Business Finance Corporation, and (iii) the other documents executed by Borrower in connection with the Bonds.

(h) Indebtedness evidenced by the Subordinated Demand Note;

(i) Indebtedness of PFSM, LLC owing to Borrower for the acquisition of equipment by PFSM, LLC, provided (i) such Indebtedness does not exceed the lesser of the cost or fair market value of the equipment financed with such Indebtedness, (ii) the aggregate principal amount of Indebtedness incurred by PFSM, LLC pursuant to this clause when added to the aggregate amount of Investments made by Borrower pursuant to clause (g) of the definition of Permitted Investments does not exceed \$450,000 in any fiscal year, and (iii) at the time of incurrence of such Indebtedness and after giving effect thereto, no Event of Default has occurred and is continuing;

(j) Indebtedness described in clause (g) of Permitted Investments (but without duplication thereof);

(k) Indebtedness described in clause (f) of Permitted Investments (but without duplication thereof);

(l) Intercompany Indebtedness incurred in connection with the allocation of certain expenses (such as expenses incurred for reports filed with the Securities and Exchange Commission) to PFSweb, Inc., provided that the aggregate amount (excluding any intercompany Indebtedness incurred to pay expenses in connection with a stock offering by PFSweb, Inc.) of such allocated expenses does not exceed \$100,000 in any fiscal year; and

(m) Extensions, refinancings and renewals of any items of Permitted Indebtedness, provided with respect to such Permitted Indebtedness (other than trade payables) that the principal amount is not increased or the terms modified to impose materially more burdensome terms upon Borrower or its Subsidiary, as the case may be.

"Permitted Investment" means:

(a) Investments existing on the Closing Date disclosed in the Schedule;

(b) (i) Marketable direct obligations issued or unconditionally guaranteed by the United States of America or any agency or any State thereof maturing within one year from the date of acquisition thereof, (ii) commercial paper maturing no more than one year from the date of creation thereof and currently having rating of at least A-2 or P-2 from either Standard & Poor's Corporation or Moody's Investors Service, (iii) Bank's certificates of deposit maturing no more than one year from the date of investment therein, and (iv) Bank's money market accounts;

(c) Repurchases of stock from former employees or directors of Borrower under the terms of applicable repurchase agreements (i) in an aggregate amount not to exceed \$100,000 in any fiscal year, provided that no Event of Default has occurred, is continuing or would exist after giving effect to the repurchases, or (ii) in any amount where the consideration for the repurchase is the cancellation of indebtedness owed by such former employees to Borrower regardless of whether an Event of Default exists;

(d) Investments accepted in connection with Permitted Transfers;

- (e) Advances by Borrower to Supplies Distributors, Inc. pursuant to the Subordinated Demand Note, so long as (1) the aggregate outstanding principal amount of such Indebtedness does not exceed \$8,005,000 (excluding accrued and unpaid interest) at any time, and (2) before and after giving effect to such advances no Event of Default has occurred and is continuing;
- (f) Investments in or advances to PFSweb B.V. by Borrower not to exceed \$1,000,000 in the aggregate in any fiscal year (excluding accrued interest), so long as before and after giving effect to such Investments or advances, no Event of Default has occurred and is continuing;
- (g) Investments in or advances to Priority Fulfillment Services of Canada, Inc. by Borrower not to exceed \$1,000,000 in the aggregate in any fiscal year (excluding accrued interest), so long as before and after giving effect to such Investments or advances, no Event of Default has occurred and is continuing;
- (h) Investments by Borrower in PFSM, LLC for the acquisition of equipment by PFSM, LLC, provided (i) each such Investment does not exceed the lesser of the cost or fair market value of the equipment acquired with such Investment, (ii) the aggregate amount of Investments made by Priority pursuant to this clause when added to the Indebtedness incurred by PFSM, LLC pursuant to clause (i) of the definition of Permitted Indebtedness does not exceed \$450,000 in any fiscal year, and (iii) at the time of each such Investment and after giving effect thereto, no Event of Default has occurred and is continuing;
- (i) Investments by Borrower in Supplies Distributors, Inc. in an amount not to exceed the aggregate cash dividends paid to Borrower by Supplies Distributors, Inc. after the date hereof, so long as at the time of and after giving effect to each such Investment, no Event of Default has occurred and is continuing;
- (j) Investments of Subsidiaries in or to other Subsidiaries or Borrower and Investments by Borrower in Subsidiaries (not described in clauses (a), (d), (e), (f), (g), (h) and (i) above), not to exceed \$100,000 in the aggregate in any fiscal year (excluding increases in Borrower's Investment in existing Subsidiaries that arise solely as a result of earnings by such Subsidiaries that are not distributed to Borrower);
- (k) Investments not to exceed \$100,000 outstanding at any time in the aggregate consisting of (i) travel advances and employee relocation loans and other employee loans and advances in the ordinary course of business, and (ii) loans to employees, officers or directors relating to the purchase of equity securities of Borrower or its Subsidiaries pursuant to employee stock purchase plan agreements approved by Borrower's Board of Directors;
- (l) Investments (including debt obligations) received in connection with the bankruptcy or reorganization of customers or suppliers and in settlement of delinquent obligations of, and other disputes with, customers or suppliers arising in the ordinary course of Borrower's business;
- (m) Investments consisting of notes receivable of, or prepaid royalties and other credit extensions, to customers and suppliers who are not Affiliates, in the ordinary course of business, provided that this subparagraph (h) shall not apply to Investments of Borrower in any Subsidiary;
- (n) Capitalization of intercompany Indebtedness that is outstanding on the date of this Agreement; and
- (o) Joint ventures or strategic alliances in the ordinary course of Borrower's business consisting of the non-exclusive licensing of technology, the development of technology or the providing of technical support, provided that any cash Investments by Borrower do not exceed \$100,000 in the aggregate in any fiscal year.

"Permitted Liens" means the following:

- (a) Any Liens existing on the Closing Date and disclosed in the Schedule (excluding Liens to be satisfied with the proceeds of the Advances) or arising under this Agreement or the other Loan Documents;

(b) Liens for taxes, fees, assessments or other governmental charges or levies, either not delinquent or being contested in good faith by appropriate proceedings and for which Borrower maintains adequate reserves, provided the same have no priority over any of Bank's security interests;

(c) Liens not to exceed (i) \$4,000,000 in the aggregate in each of Borrower's fiscal years 2004 and 2005, and (ii) \$3,000,000 beginning with Borrower's 2005 fiscal year and each fiscal year thereafter (1) upon or in any Equipment acquired or held by Borrower or any of its Subsidiaries to secure the purchase price of such Equipment or indebtedness incurred solely for the purpose of financing the acquisition or lease of such Equipment, or (2) existing on such Equipment at the time of its acquisition, provided that the Lien is confined solely to the property so acquired and improvements thereon, and the proceeds of such Equipment;

(d) Liens incurred in connection with the extension, renewal or refinancing of the indebtedness secured by Liens of the type described in clauses (a) through (c) above, provided that any extension, renewal or replacement Lien shall be limited to the property encumbered by the existing Lien and the principal amount of the indebtedness being extended, renewed or refinanced does not increase;

(e) Liens arising from judgments, decrees or attachments in circumstances not constituting an Event of Default under Sections 8.5 or 8.9;

(f) Liens securing the Bonds;

(g) Liens in favor of other financial institutions arising in connection with Borrower's deposit accounts held at such institutions, provided that Bank has a perfected security interest in the amounts held in such deposit accounts other than the deposit accounts listed in the Schedule and any Third Party Deposit Account; and

(h) Other Liens not described above arising in the ordinary course of business and not having or not reasonably likely to have a Material Adverse Effect on Borrower and its Subsidiaries taken as a whole.

"Permitted Transfer" means the conveyance, sale, lease, transfer or disposition by Borrower or any Subsidiary of:

(a) Inventory in the ordinary course of business;

(b) licenses and similar arrangements for the use of the property of Borrower or its Subsidiaries in the ordinary course of business;

(c) worn-out or obsolete Equipment;

(d) any Equipment under a sale-leaseback transaction approved by Bank;

(e) any transfer of assets made by Borrower to PFSweb B.V. in connection with the reincorporation of PFSweb B.V. under the laws of Belgium, provided that such assets were originally transferred to such Borrower by PFSweb B.V. in connection with its reincorporation; or

(f) other assets of Borrower or its Subsidiaries the gross sales proceeds of which do not in the aggregate exceed \$250,000 during any fiscal year.

"Person" means any individual, sole proprietorship, partnership, limited liability company, joint venture, trust, unincorporated organization, association, corporation, institution, public benefit corporation, firm, joint stock company, estate, entity or governmental agency.

"Prime Rate" means the variable rate of interest, per annum, most recently announced by Bank, as its "prime rate," whether or not such announced rate is the lowest rate available from Bank.

"Reimbursement Agreement" means that certain Reimbursement Agreement dated as of November 1, 2004, between Borrower and Bank, as from time to time amended or modified, which was executed in connection with the Bonds.

"Responsible Officer" means each of the Chief Executive Officer, the Chief Operating Officer, the Chief Financial Officer and the Corporate Controller of Borrower.

"Revolving Facility" means the facility under which Borrower may request Bank to issue Advances, as specified in Section 2.1(b) hereof.

"Revolving Maturity Date" means March 2, 2007.

"Schedule" means the schedule of exceptions attached hereto and approved by Bank, if any.

"SOS Reports" means the official reports from the Secretaries of State or other applicable governmental official of each Collateral State, Chief Executive Office and the Organizational Jurisdiction and other applicable federal, state or local government offices identifying all current security interests filed in the Collateral and Liens of record as of the date of such report.

"Standby Letter of Credit" means a letter of credit to be issued in connection with the Bonds on December 29, 2004, for the account of Borrower in the stated amount of \$5,061,643.84 and for the benefit of U.S. Bank National Association, as Trustee.

"Subordinated Debt" means any debt incurred by Borrower that is subordinated in writing to the debt owing by Borrower to Bank on terms reasonably acceptable to Bank (and identified as being such by Borrower and Bank), including all obligations owing by Borrower to IBM Belgium Financial Services S.A., Congress Financial Corporation (Southwest) or IBM Credit Corporation that is expressly subordinated by the Subordination Agreements of even date herewith, as from time to time amended, modified or restated.

"Subordinated Demand Note" means the promissory note dated November 12, 2002, in the stated principal amount of \$8,000,000, from Supplies Distributor, Inc. to Borrower, which has been subordinated to all obligations of Supplies Distributors, Inc. owed to IBM Credit Corporation, Congress Financial Corporation (Southwest) and IBM Belgium Financial Services S.A.

"Subsidiary" means any corporation, partnership or limited liability company or joint venture in which (i) any general partnership interest or (ii) more than 50% of the stock, limited liability company interest or joint venture of which by the terms thereof ordinary voting power to elect the Board of Directors, managers or trustees of the entity, at the time as of which any determination is being made, is owned by Borrower, either directly or through an Affiliate.

"Tangible Net Worth" means at any date as of which the amount thereof shall be determined (a) the consolidated shareholder equity of Guarantor (excluding foreign currency translation accounts), minus (b) goodwill.

"Third Party Deposit Accounts" means those deposit accounts now existing or hereafter established by Borrower for deposits of funds received by Borrower on behalf of its account debtors in payment of such account debtors' receivables, provided that such deposit accounts are titled to clearly indicate that Borrower maintains such deposit accounts on behalf of its account debtors.

"Trademarks" means any trademark and servicemark rights, whether registered or not, applications to register and registrations of the same and like protections, and the entire goodwill of the business of Borrower connected with and symbolized by such trademarks.

"Tranche A" has the meaning assigned in Section 2.1(c)(i).

"Tranche B" has the meaning assigned in Section 2.1(c)(i).

"Tranche A Equipment Advance" or "Tranche A Equipment Advances" means any Equipment Advances(s) made under Tranche A.

"Tranche B Equipment Advance" or "Tranche B Equipment Advances" means any Equipment Advances(s) made under Tranche B.

"Tranche A Availability End Date" means June \_\_\_\_, 2005.

"Tranche B Availability End Date" means December \_\_\_\_, 2005.



**DEBTOR PRIORITY FULFILLMENT SERVICES, INC.**

**SECURED PARTY: COMERICA BANK**

**EXHIBIT B**

**COLLATERAL DESCRIPTION ATTACHMENT  
TO FIRST AMENDED AND RESTATED LOAN AND SECURITY AGREEMENT**

All personal property of Borrower (herein referred to as "Borrower" or "Debtor") whether presently existing or hereafter created or acquired, and wherever located, including, but not limited to:

(a) all accounts (including health-care-insurance receivables), chattel paper (including tangible and electronic chattel paper), deposit accounts (other than the Third Party Deposit Accounts), documents (including negotiable documents), equipment (including all accessions and additions thereto), general intangibles (including payment intangibles and software), goods (including fixtures), instruments (including promissory notes), inventory (including all goods held for sale or lease or to be furnished under a contract of service, and including returns and repossessions), investment property (including securities and securities entitlements), letter of credit rights, money, and all of Debtor's books and records with respect to any of the foregoing, and the computers and equipment containing said books and records;

(b) all common law and statutory copyrights and copyright registrations, applications for registration, now existing or hereafter arising, in the United States of America or in any foreign jurisdiction, obtained or to be obtained on or in connection with any of the foregoing, or any parts thereof or any underlying or component elements of any of the foregoing, together with the right to copyright and all rights to renew or extend such copyrights and the right (but not the obligation) of Secured Party to sue in its own name and/or in the name of the Debtor for past, present and future infringements of copyright;

(c) all trademarks, service marks, trade names and service names and the goodwill associated therewith, together with the right to trademark and all rights to renew or extend such trademarks and the right (but not the obligation) of Secured Party to sue in its own name and/or in the name of the Debtor for past, present and future infringements of trademark;

(d) all (i) patents and patent applications filed in the United States Patent and Trademark Office or any similar office of any foreign jurisdiction, and interests under patent license agreements, including, without limitation, the inventions and improvements described and claimed therein, (ii) licenses pertaining to any patent whether Debtor is licensor or licensee, (iii) income, royalties, damages, payments, accounts and accounts receivable now or hereafter due and/or payable under and with respect thereto, including, without limitation, damages and payments for past, present or future infringements thereof, (iv) right (but not the obligation) to sue in the name of Debtor and/or in the name of Secured Party for past, present and future infringements thereof, (v) rights corresponding thereto throughout the world in all jurisdictions in which such patents have been issued or applied for, and (vi) reissues, divisions, continuations, renewals, extensions and continuations-in-part with respect to any of the foregoing;

(e) All ownership interest of Debtor in Supplies Distributors Holdings, LLC and PFSM, LLC, together with all dividends and other distributions at any time made with respect to such ownership interests; and

(f) any and all cash proceeds and/or noncash proceeds of any of the foregoing, including, without limitation, insurance proceeds, and all supporting obligations and the security therefor or for any right to payment. All terms above have the meanings given to them in the California Uniform Commercial Code, as amended or supplemented from time to time, including revised Division 9 of the Uniform Commercial Code-Secured Transactions, added by Stats. 1999, c.991 (S.B. 45), Section 35, operative July 1, 2001.

**EXHIBIT C**

**LOAN PAYMENT/ADVANCE TELEPHONE REQUEST FORM**

**DEADLINE FOR SAME DAY PROCESSING IS 3:00 P.M., P.S.T.**

TO: [\_\_\_\_\_]

DATE: \_\_\_\_\_

FAX #: [\_\_\_\_\_]

TIME: \_\_\_\_\_

FROM: PRIORITY FULFILLMENT SERVICES, INC.

**CLIENT NAME (BORROWER)**

**REQUESTED BY:** \_\_\_\_\_

**AUTHORIZED SIGNER'S NAME**

**AUTHORIZED SIGNATURE:** \_\_\_\_\_

**PHONE NUMBER:** \_\_\_\_\_

**FROM ACCOUNT #** \_\_\_\_\_ **TO ACCOUNT #** \_\_\_\_\_

REQUESTED TRANSACTION TYPE

REQUEST DOLLAR AMOUNT

\$ \_\_\_\_\_

PRINCIPAL INCREASE (ADVANCE)

\$ \_\_\_\_\_

PRINCIPAL PAYMENT (ONLY)

\$ \_\_\_\_\_

INTEREST PAYMENT (ONLY)

\$ \_\_\_\_\_

PRINCIPAL AND INTEREST (PAYMENT)

\$ \_\_\_\_\_

**OTHER INSTRUCTIONS:** \_\_\_\_\_

All representations and warranties of Borrower stated in the First Amended and Restated Loan and Security Agreement are true, correct and complete in all material respects as of the date of the telephone request for an Advance confirmed by this Borrowing Certificate; provided, however, that those representations and warranties expressly referring to another date shall be true, correct and complete in all material respects as of such date.

**BANK USE ONLY**

**TELEPHONE REQUEST:**

The following person is authorized to request the loan payment transfer/loan advance on the advance designated account and is known to me.

\_\_\_\_\_  
Authorized Requester

\_\_\_\_\_  
Phone #

\_\_\_\_\_  
Received By (Bank)

\_\_\_\_\_  
Phone #

\_\_\_\_\_  
Authorized Signature (Bank)

## EXHIBIT D

### BORROWING BASE CERTIFICATE

Borrower: Priority Fulfillment Services, Inc. Lender: \_\_\_\_\_ Bank

Commitment Amount: \$5,000,000

#### ACCOUNTS RECEIVABLE

1.	Accounts Receivable Book Value as of ____	\$ _____
2.	Additions (please explain on reverse)	\$ _____
3.	TOTAL ACCOUNTS RECEIVABLE	\$ _____

#### ACCOUNTS RECEIVABLE DEDUCTIONS (without duplication)

4.	Amounts over 90 days due	\$ _____
5.	Balance of 25% over 90 day accounts	\$ _____
6.	Concentration Limits	\$ _____
7.	Foreign Accounts	\$ _____
8.	Governmental Accounts	\$ _____
9.	Contra Accounts	\$ _____
10.	Demo Accounts	\$ _____
11.	Intercompany/Employee Accounts	\$ _____
12.	Credit Card Accounts	\$ _____
13.	Other (please explain on reverse)	\$ _____
14.	TOTAL ACCOUNTS RECEIVABLE DEDUCTIONS	\$ _____
15.	Eligible Accounts (#3 minus #14)	\$ _____
16.	LOAN VALUE OF ACCOUNTS (80% of #15)	\$ _____

#### BALANCES

17.	Maximum Loan Amount	\$5,000,000
18.	Total Funds Available [Lesser of #17 or #16]	\$ _____
19.	Present balance owing on Line of Credit	\$ _____
20.	Outstanding under Sublimit (Letters of Credit)	\$ _____
21.	RESERVE POSITION (#18 minus #19 and #20)	\$ _____

The undersigned represents and warrants that the foregoing is true, complete and correct in all material respects, and that the information reflected in this Borrowing Base Certificate complies with the representations and warranties set forth in the First Amended and Restated Loan and Security Agreement between the undersigned and Comerica Bank.

**PRIORITY FULFILLMENT SERVICES, INC.**

By: \_\_\_\_\_ Authorized Signer

EXHIBIT E  
COMPLIANCE CERTIFICATE

TO: COMERICA BANK

FROM: PRIORITY FULFILLMENT SERVICES, INC.

The undersigned authorized officer of PRIORITY FULFILLMENT SERVICES, INC. hereby certifies that in accordance with the terms and conditions of the First Amended and Restated Loan and Security Agreement between Borrower and Bank (the "Agreement"), (i) Borrower is in complete compliance for the period ending \_\_\_\_\_ with all required covenants, including without limitation the ongoing registration of intellectual property rights in accordance with Section 6.8, except as noted below and (ii) all representations and warranties of Borrower stated in the Agreement are true and correct in all material respects as of the date hereof. Attached herewith are the required documents supporting the above certification. The Officer further certifies that these are prepared in accordance with Generally Accepted Accounting Principles (GAAP) and are consistently applied from one period to the next except as explained in an accompanying letter or footnotes.

**PLEASE INDICATE COMPLIANCE STATUS BY CIRCLING YES/NO UNDER "COMPLIES" COLUMN.**

REPORTING COVENANT -----	REQUIRED -----	ACTUAL -----	COMPLIES -----	
Monthly financial statements	Monthly within 35 days		Yes	No
Annual (CPA Audited) of Guarantor	FYE within 90 days		Yes	No
Annual (CPA Audited) of BSD	FYE within 90 days		Yes	No
10K of Guarantor	FYE within 90 days		Yes	No
10Q of Guarantor	Quarterly within 45 days		Yes	No
A/R & A/P Agings, Borrowing Base Cert.	Monthly within 30 days*		Yes	No
A/R Audit	Annual		Yes	No
IP Report	Quarterly within 30 days		Yes	No
Tangible Net Worth				
	\$21,000,000	\$_____	Yes	No

\*Weekly during any period that Adjusted Tangible Net Worth is less than \$21,000,000

FINANCIAL COVENANT -----	REQUIRED -----	ACTUAL -----	COMPLIES -----	
Maintain on a Monthly Basis:				
Liquidity Ratio	1.25:1.00	_____:1.00	Yes	No
EBITDA	SEE SECTION 6.7(d)	\$_____	Yes	No
Minimum Tangible Net Worth	> of \$20,000,000 or \$2,000,000 plus IBM et al requirement	\$_____	Yes	No
Minimum Cash	\$1,250,000*	\$_____	Yes	No

\*subject to adjustment based on appraisal of Equipment

**COMMENTS REGARDING EXCEPTIONS: See Attached.**

**BANK USE ONLY**

Sincerely,

\_\_\_\_\_  
SIGNATURE

Received by: \_\_\_\_\_  
AUTHORIZED SIGNER

Date: \_\_\_\_\_

Verified: \_\_\_\_\_  
AUTHORIZED SIGNER

Date: \_\_\_\_\_

**TITLE**

**Compliance Status Yes No**

**DATE**

## **SCHEDULE OF EXCEPTIONS**

**Permitted Indebtedness (Exhibit A)**

**Permitted Investments (Exhibit A)**

**Permitted Liens (Exhibit A)**

**Prior Names (Section 5.5)**

**Litigation (Section 5.6)**

**Outgoing Wires (Section 7.13)**

## **CORPORATION RESOLUTIONS AND INCUMBENCY CERTIFICATION AUTHORITY TO PROCURE LOANS**

I certify that I am the duly elected and qualified Secretary of Priority Fulfillment Services, Inc. (the "Corporation"); that the following is a true and correct copy of resolutions duly adopted by the Board of Directors of the Corporation in accordance with its bylaws and applicable statutes.

### **COPY OF RESOLUTIONS:**

#### **Be it Resolved, That:**

1. Any one (1) of the following \_\_\_\_\_ (insert titles only) of the Corporation is authorized, for, on behalf of, and in the name of the Corporation to:

(a) Negotiate and procure loans, letters of credit and other credit or financial accommodations from Comerica Bank ("Bank"), including, without limitation, that certain First Amended and Restated Loan and Security Agreement dated as of December \_\_\_\_\_, 2004, as it may subsequently be amended from time to time.

(b) Discount with the Bank, commercial or other business paper belonging to the Corporation made or drawn by or upon third parties, without limit as to amount;

(c) Purchase, sell, exchange, assign, endorse for transfer and/or deliver certificates and/or instruments representing stocks, bonds, evidences of Indebtedness or other securities owned by the Corporation, whether or not registered in the name of the Corporation;

(d) Give security for any liabilities of the Corporation to the Bank by grant, security interest, assignment, lien, deed of trust or mortgage upon any real or personal property, tangible or intangible of the Corporation;

(e) Issue a warrant or warrants to purchase the Corporation's capital stock; and

(f) Execute and deliver in form and content as may be required by the Bank any and all notes, evidences of Indebtedness, applications for letters of credit, guaranties, subordination agreements, loan and security agreements, financing statements, assignments, liens, deeds of trust, mortgages, trust receipts and other agreements, instruments or documents to carry out the purposes of these Resolutions, any or all of which may relate to all or to substantially all of the Corporation's property and assets.

2. Said Bank be and it is authorized and directed to pay the proceeds of any such loans or discounts as directed by the persons so authorized to sign, whether so payable to the order of any of said persons in their individual capacities or not, and whether such proceeds are deposited to the individual credit of any of said persons or not;

3. Any and all agreements, instruments and documents previously executed and acts and things previously done to carry out the purposes of these Resolutions are ratified, confirmed and approved as the act or acts of the Corporation.

4. These Resolutions shall continue in force, and the Bank may consider the holders of said offices and their signatures to be and continue to be as set forth in a certified copy of these Resolutions delivered to the Bank, until notice to the contrary in writing is duly served on the Bank (such notice to have no effect on any action previously taken by the Bank in reliance on these Resolutions).

5. Any person, corporation or other legal entity dealing with the Bank may rely upon a certificate signed by an officer of the Bank to effect that these Resolutions and any agreement, instrument or document executed pursuant to them are still in full force and effect and binding upon the Corporation.

6. The Bank may consider the holders of the offices of the Corporation and their signatures, respectively, to be and continue to be as set forth in the Certificate of the Secretary of the Corporation until notice to the contrary in writing is duly served on the Bank.

I further certify that the above Resolutions are in full force and effect as of the date of this Certificate; that these Resolutions and any borrowings or financial accommodations under these Resolutions have been properly noted in the corporate books and records, and have not been rescinded, annulled, revoked or modified; that neither the foregoing Resolutions nor any actions to be taken pursuant to them are or will be in contravention of any provision of the articles of incorporation or bylaws of the Corporation or of any agreement, indenture or other instrument to which the Corporation is a party or by which it is bound; and that neither the articles of incorporation nor bylaws of the Corporation nor any agreement, indenture or other instrument to which the Corporation is a party or by which it is bound require the vote or consent of shareholders of the Corporation to authorize any act, matter or thing described in the foregoing Resolutions.

I further certify that the following named persons have been duly elected to the offices set opposite their respective names, that they continue to hold these offices at the present time, and that the signatures which appear below are the genuine, original signatures of each respectively:

(PLEASE SUPPLY GENUINE SIGNATURES OF AUTHORIZED SIGNERS BELOW)

NAME (TYPE OR PRINT)	TITLE	SIGNATURE

In Witness Whereof, I have affixed my name as Secretary and have caused the corporate seal (where available) of said Corporation to be affixed on December \_\_\_\_\_, 2004.

\_\_\_\_\_  
**Secretary**

\*\*\*

**The Above Statements are Correct.** \_\_\_\_\_  
SIGNATURE OF OFFICER OR DIRECTOR OR, IF NONE. A SHAREHOLDER OTHER THAN SECRETARY WHEN SECRETARY IS AUTHORIZED TO SIGN ALONE.

Failure to complete the above when the Secretary is authorized to sign alone shall constitute a certification by the Secretary that the Secretary is the sole Shareholder, Director and Officer of the Corporation.

**COMERICA BANK  
MEMBER FDIC**

**ITEMIZATION OF AMOUNT FINANCED  
DISBURSEMENT INSTRUCTIONS  
(REVOLVER)**

**Name(s): PRIORITY FULFILLMENT SERVICES, INC. Date:**

\$ credited to deposit account No. \_\_\_\_\_ when Advances are requested or disbursed to Borrower by cashiers check or wire transfer

Amounts paid to others on your behalf:

**\$ to Comerica Bank for Loan Fee**

**\$ to Comerica Bank for Document Fee**

\$ to Comerica Bank for accounts receivable audit (estimate)

\$ to Bank counsel fees and expenses

\$ to \_\_\_\_\_

\$ to \_\_\_\_\_

**\$ TOTAL (AMOUNT FINANCED)**

Upon consummation of this transaction, this document will also serve as the authorization for Comerica Bank to disburse the loan proceeds as stated above.

---

**Signature Signature**



**COMERICA BANK  
MEMBER FDIC**

**ITEMIZATION OF AMOUNT FINANCED  
DISBURSEMENT INSTRUCTIONS  
(TERM LOAN)**

**Name(s): PRIORITY FULFILLMENT SERVICES, INC. Date:**

\$ credited to deposit account No. \_\_\_\_\_ when Advances are requested or disbursed to Borrower by cashiers check or wire transfer

Amounts paid to others on your behalf:

**\$ to Comerica Bank for Loan Fee**

**\$ to Comerica Bank for Document Fee**

\$ to Comerica Bank for accounts receivable audit (estimate)

\$ to Bank counsel fees and expenses

\$ to \_\_\_\_\_

\$ to \_\_\_\_\_

**\$ TOTAL (AMOUNT FINANCED)**

Upon consummation of this transaction, this document will also serve as the authorization for Comerica Bank to disburse the loan proceeds as stated above.

---

**Signature Signature**

## AGREEMENT TO PROVIDE INSURANCE

TO: COMERICA BANK  
Attn: Deni M. Snider, MC 4770  
75 E. Trimble Road  
San Jose, CA 95131

Date: \_\_\_\_\_  
Borrower: PRIORITY FULFILLMENT  
SERVICES, INC.

In consideration of a loan in the amount of [\_\_\_\_\_], secured by all tangible personal property including inventory and equipment.

I/We agree to obtain adequate insurance coverage to remain in force during the term of the loan.

I/We also agree to advise the below named agent to add Comerica Bank as lender's loss payable on the new or existing insurance policy, and to furnish Bank at above address with a copy of said policy/endorsements and any subsequent renewal policies.

I/We understand that the policy must contain:

1. Fire and extended coverage in an amount sufficient to cover:

(a) The amount of the loan, OR

(b) All existing encumbrances, whichever is greater,

But not in excess of the replacement value of the improvements on the real property.

2. Lender's "Loss Payable" Endorsement Form 438 BFU in favor of Comerica Bank, or any other form acceptable to Bank.

### INSURANCE INFORMATION

**Insurance Co./Agent Telephone No.:**

**Agent's Address:**

Signature of Obligor: \_\_\_\_\_

Signature of Obligor: \_\_\_\_\_

### FOR BANK USE ONLY

**INSURANCE VERIFICATION: Date:** \_\_\_\_\_

Person Spoken to: \_\_\_\_\_

Policy Number: \_\_\_\_\_

Effective From: \_\_\_\_\_ To: \_\_\_\_\_

Verified by: \_\_\_\_\_

**COMERICA BANK**  
**CALIFORNIA'S BUSINESS BANKS AUTOMATIC DEBIT AUTHORIZATION**  
**MEMBER FDIC**

**To: COMERICA BANK**

Re: LOAN # \_\_\_\_\_

You are hereby authorized and instructed to charge account No. \_\_\_\_\_ in the name of PRIORITY FULFILLMENT SERVICES, INC. for principal, interest and other payments due on above referenced loan as set forth below and credit the loan referenced above.

\_\_\_\_ Debit each interest payment as it becomes due according to the terms of the First Amended and Restated Loan and Security Agreement and any renewals or amendments thereof.

\_\_\_\_ Debit each principal payment as it becomes due according to the terms of the First Amended and Restated Loan and Security Agreement and any renewals or amendments thereof.

\_\_\_\_ Debit each payment for Bank Expenses as it becomes due according to the terms of the First Amended and Restated Loan and Security Agreement and any renewals or amendments thereof.

This Authorization is to remain in full force and effect until revoked in writing.

Borrower Signature  
-----

Date  
----

\_\_\_\_\_  
\_\_\_\_\_

\_\_\_\_\_  
\_\_\_\_\_

## EXHIBIT A to UCC Financing Statement

Secured Party: Comerica Bank

Debtor: Priority Fulfillment Services, Inc.

### COLLATERAL DESCRIPTION ATTACHMENT TO FIRST AMENDED AND RESTATED LOAN AND SECURITY AGREEMENT

All personal property of Borrower (herein referred to as "Borrower" or "Debtor") whether presently existing or hereafter created or acquired, and wherever located, including, but not limited to:

(a) all accounts (including health-care-insurance receivables), chattel paper (including tangible and electronic chattel paper), deposit accounts (other than the Third Party Deposit Accounts), documents (including negotiable documents), equipment (including all accessions and additions thereto), general intangibles (including payment intangibles and software), goods (including fixtures), instruments, goods (including fixtures), instruments (including promissory notes), inventory (including all goods held for sale or lease or to be furnished under a contract of service, and including returns and repossessions), investment property (including securities and securities entitlements), letter of credit rights, money, and all of Debtor's books and records with respect to any of the foregoing, and the computers and equipment containing said books and records;

(b) all common law and statutory copyrights and copyright registrations, applications for registration, now existing or hereafter arising, in the United States of America or in any foreign jurisdiction, obtained or to be obtained on or in connection with any of the foregoing, or any parts thereof or any underlying or component elements of any of the foregoing, together with the right to copyright and all rights to renew or extend such copyrights and the right (but not the obligation) of Secured Party to sue in its own name and/or in the name of the Debtor for past, present and future infringements of copyright;

(c) all trademarks, service marks, trade names and service names and the goodwill associated therewith, together with the right to trademark and all rights to renew or extend such trademarks and the right (but not the obligation) of Secured Party to sue in its own name and/or in the name of the Debtor for past, present and future infringements of trademark;

(d) all (i) patents and patent applications filed in the United States Patent and Trademark Office or any similar office of any foreign jurisdiction, and interests under patent license agreements, including, without limitation, the inventions and improvements described and claimed therein, (ii) licenses pertaining to any patent whether Debtor is licensor or licensee, (iii) income, royalties, damages, payments, accounts and accounts receivable now or hereafter due and/or payable under and with respect thereto, including, without limitation, damages and payments for past, present or future infringements thereof, (iv) right (but not the obligation) to sue in the name of Debtor and/or in the name of Secured Party for past, present and future infringements thereof, (v) rights corresponding thereto throughout the world in all jurisdictions in which such patents have been issued or applied for, and (vi) reissues, divisions, continuations, renewals, extensions and continuations-in-part with respect to any of the foregoing;

(e) all ownership interests of Debtor in Supplies Distributors Holdings, LLC and PFSM, LLC, together with all dividends and other distributions at any time made with respect to such ownership interest; and

(f) any and all cash proceeds and/or noncash proceeds of any of the foregoing, including, without limitation, insurance proceeds, and all supporting obligations and the security therefor or for any right to payment. All terms above have the meanings given to them in the California Uniform Commercial Code, as amended or supplemented from time to time, including revised Division 9 of the Uniform Commercial Code-Secured Transactions, added by Stats. 1999, c.991 (S.B. 45), Section 35, operative July 1, 2001.

As used herein, the term "Third Party Deposit Accounts" means these deposit accounts now existing or hereafter established by Debtor for deposits of funds received by Debtor on behalf of its account debtors in payment of such account debtors' receivables; provided that such deposit accounts are titled to clearly indicate that Borrower maintains such deposit accounts on behalf of its account debtors.

**REMARKETING AGREEMENT**

**BETWEEN**

**PRIORITY FULFILLMENT SERVICES, INC.**  
(THE "OBLIGOR")

**AND**

**COMERICA SECURITIES**  
(THE "REMARKETING AGENT")

**DATED AS OF NOVEMBER 1, 2004**

**RELATING TO**

**\$5,000,000**  
**MISSISSIPPI BUSINESS FINANCE CORPORATION**  
**TAXABLE VARIABLE RATE DEMAND LIMITED OBLIGATION**  
**REVENUE BONDS, SERIES 2004**  
(PRIORITY FULFILLMENT SERVICES, INC. PROJECT)

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## REMARKETING AGREEMENT

THIS REMARKETING AGREEMENT (the "Agreement") dated as of November 1, 2004 by and between PRIORITY FULFILLMENT SERVICES, INC., a Delaware corporation (the "Obligor") and COMERICA SECURITIES (the "Remarketing Agent").

WHEREAS, the Mississippi Business Finance Corporation (the "Issuer") has appointed the Remarketing Agent (and the Remarketing Agent hereby accepts the appointment) as Remarketing Agent under the Trust Indenture dated as of the date of this Agreement (the "Indenture") between the Issuer and U.S. Bank National Association, as trustee (the "Trustee"), relating to the Issuer's \$5,000,000 principal amount Taxable Variable Rate Demand Limited Obligation Revenue Bonds, Series 2004 (Priority Fulfillment Services, Inc. Project) (the "Bonds"); and

WHEREAS, the Obligor has entered into a Loan Agreement dated as of the date of this Agreement (the "Loan Agreement") between the Issuer and the Obligor; and

WHEREAS, the Remarketing Agent has been appointed by the Issuer to use its best efforts to remarket the Bonds subject to optional or mandatory purchase and to determine the interest rate necessary to remarket the Bonds at par; and

WHEREAS, the Obligor and Remarketing Agent desire to make additional provisions regarding the Remarketing Agent's role as Remarketing Agent for the Bonds with respect to its obligations described in Section 203 of the Indenture. Terms used in this Agreement without being defined have the meanings given them in the Indenture.

NOW, THEREFORE, the Obligor and Remarketing Agent hereby agrees as follows:

### SECTION 1. DUTIES.

(a) The Remarketing Agent will perform the duties specified as Remarketing Agent under the Indenture, including, but not limited to, the determination of interest rates as set forth in Section 110 of the Indenture and the remarketing of the Bonds as set forth in Section 203 of the Indenture. Unless the Remarketing Agent is otherwise directed in writing by the Obligor and except as provided in the next paragraph, the Remarketing Agent shall use its best efforts to remarket Bonds subject to optional or mandatory purchase under Sections 201 and 202 of the Indenture, respectively. Bonds which are subject to mandatory purchase on the Conversion Date, a proposed Conversion Date or a Substitution Date shall be remarketed by the Remarketing Agent only to a buyer to whom the Remarketing Agent has delivered, at the time of such remarketing, a copy of the notice of conversion or notice of delivery of a Substitute Credit Facility, as applicable, pursuant to Section 113(b) of the Indenture. In the event the Bonds are remarketed pursuant to a mandatory purchase on the Conversion Date, a proposed Conversion Date or a Substitution Date, the Remarketing Agent shall be entitled to a fee (mutually agreed upon with the Obligor prior to the commencement of the remarketing) in addition to the annual remarketing fee received pursuant to Section 4 hereof. In acting as Remarketing Agent, the

Remarketing Agent will act as agent and not as principal except as expressly provided in this Section 1.

(b) The Remarketing Agent may, if it determines to do so in its sole discretion, buy as principal, but it will not in any event be obligated to do so, and if it buys Bonds it will have the same rights as would any other person holding the Bonds.

**SECTION 2. DISCLOSURE STATEMENT.** If the Remarketing Agent determines that it is necessary or desirable to use a disclosure statement in connection with its offering of Bonds (a "Disclosure Statement"), and in any event upon conversion of the interest rate on the Bonds to a Fixed Rate, the Remarketing Agent will notify the Obligor and the Obligor will provide the Remarketing Agent with a Disclosure Statement satisfactory to the Remarketing Agent and its Counsel in respect of the Bonds. The Obligor will supply the Remarketing Agent, at the Obligor's expense, with such number of copies of the Disclosure Statement as the Remarketing Agent requests from time to time and will amend the document with respect to the Obligor and any summary of documents the amendment of which was approved by the Obligor (and/or the documents incorporated by reference in it) so that at all times the document will not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements in the document, in light of the circumstances under which they were made, not misleading.

**SECTION 3. INDEMNIFICATION AND CONTRIBUTION.**

(a) The Obligor will indemnify and hold harmless the Remarketing Agent, each of its directors, officers, employees and agents and each person who controls the Remarketing Agent within the meaning of Section 15 of the Securities Act of 1933, as amended (such Act being herein called the "Act" and any such person being herein sometimes called for purposes of this paragraph (a) an "Indemnified Party"), against any and all losses, claims, damages or liabilities, joint or several, to which such Indemnified Party may become subject under any statute or at law or in equity or otherwise, and will reimburse any such Indemnified Party for any legal or other expenses incurred by it in connection with investigating any claims against it and defending any actions, insofar as such losses, claims, damages, liabilities or actions arise out of or are based upon any untrue statements, or alleged untrue statement, of a material fact with respect to the Obligor contained in any Disclosure Statement referred to in Section 2 hereof or any amendment or supplement thereto, or any portion of the Disclosure Statement under the headings "Introductory Statement," "The Obligor and the Use of Proceeds," "The Bonds" (other than the information under the sub-heading "Book-Entry System"), "Sources of Payment and Security," "The Letter of Credit," "The Loan Agreement," "The Trust Indenture," "The Reimbursement Agreement," and "The Pledge and Security Agreement," or the omission or alleged omission to state therein a material fact necessary to make the statements therein with respect to the Obligor or under such headings not misleading. This indemnity agreement will not be construed as a limitation on any other liability which the Obligor may otherwise have to any Indemnified Party, but in no event shall the Obligor be obligated for double indemnification. The duty of the Obligor to indemnify and hold the Issuer and its directors, officers, employees and agents harmless shall be governed by Section 5.4 of the Loan Agreement, the provisions of which are incorporated herein by this reference.



(b) The Remarketing Agent will indemnify and hold harmless the Obligor, each of its directors, officers, partners, employees and agents and each person who controls the Obligor within the meaning of Section 15 of the Act (for purposes of this paragraph (b), an "Indemnified Party") to the same extent as the foregoing indemnity in paragraph (a) from the Obligor to the Remarketing Agent, but only with reference to written information, if any, relating to the Remarketing Agent furnished to the Obligor by the Remarketing Agent specifically for use in the preparation of a Disclosure Statement. This indemnity agreement shall not be construed as a limitation on any other liability which the Remarketing Agent may otherwise have to any Indemnified Party, but in no event shall the Remarketing Agent be obligated for double indemnification.

(c) An Indemnified Party (as defined in paragraph (a) or paragraph

(b) of this Section 3) will, promptly after receiving notice of the commencement of any action against such Indemnified Party in respect of which indemnification may be sought against the Obligor or the Remarketing Agent, as the case may be (the "Indemnifying Party"), notify the Indemnifying Party in writing of the commencement of the action. Failure of the Indemnified Party to give such notice will reduce the liability of the Indemnifying Party under this Agreement by the amount of the damages attributable to the failure to give the notice; but the failure will not relieve the Indemnifying Party from any liability which it may have to such Indemnified Party otherwise than under the indemnity agreement in this Section 3. If such action is brought against an Indemnified Party and such Indemnified Party notifies the Indemnifying Party of the commencement of the action, the Indemnifying Party may, or if so requested by the Indemnified Party shall, participate in it or assume its defense, with counsel reasonably satisfactory to the Indemnified Party, and after notice from the Indemnifying Party to the Indemnified Party of an election so to assume the defense, the Indemnifying Party will not be liable to the Indemnified Party under this Section 3 for any legal or other expenses subsequently incurred by such Indemnified Party in connection with the defense other than reasonable costs of investigation. If the Indemnifying Party does not employ counsel to take charge of the defense or if any Indemnified Party reasonably concludes that there may be defenses available to it which are different from or in addition to those available to the Indemnifying Party (in which case the Indemnifying Party will not have the right to direct the defense of such action on behalf of such Indemnified Party), legal and other expenses reasonably incurred by such Indemnified Party will be paid by the Indemnifying Party.

(d) In order to provide for just and equitable contribution in circumstances in which the indemnification provided for in paragraph (a) of this Section 3 is due in accordance with its terms but is for any reason held by a court to be unavailable from the Obligor on grounds of policy or otherwise, the Obligor and Remarketing Agent shall contribute to the total losses, claims, damages and liabilities (including legal or other expenses reasonably incurred in connection with investigating or defending the same) to which the Obligor and Remarketing Agent may be subject in such proportion so that the Remarketing Agent is responsible for that portion represented by the percentage that the fee to be paid to the Remarketing Agent under Section 4 hereof bears to the principal amount of the Bonds remarketed under this Agreement and the Obligor is responsible for the balance; but (i) in no case will the Remarketing Agent be responsible for any amount in excess of the fee applicable to the Bonds remarketed by the

Remarketing Agent under this Agreement and (ii) no person guilty of fraudulent misrepresentation (within the meaning of section 11(f) of the Act) will be entitled to contribution from any person who was not guilty of such fraudulent misrepresentation. For purposes of this Section 3 (d), each person who controls the Remarketing Agent within the meaning of Section 15 of the Act will have the same rights to contribution as the Remarketing Agent and each person who controls the Obligor within the meaning of Section 15 of the Act and each officer, each director and each partner of the Obligor will have the same rights to contribute as the Obligor, subject in each case to clause (i) and (ii) of this Section 3 (d). Any party entitled to contribution will, promptly after receiving notice of commencement of any action, suit or proceeding against such party in respect of which a claim for contribution may be made under this Section 3(d), notify each party from whom contribution may be sought, but the failure to notify such party shall not relieve any party from whom contribution may be sought from any other obligation it may have under this Agreement or otherwise than under this Section 3(d).

**SECTION 4. FEES AND EXPENSES.** In consideration of the Remarketing Agent's services under this Agreement, the Obligor will pay the Remarketing Agent a fee of 1/4 of 1% of the aggregate principal amount of Bonds at closing. Thereafter, the Obligor will pay in advance a non-refundable fee of 1/8 of 1% per annum of the aggregate principal amount of the Bonds outstanding payable on December 1 of each year (taking into account any payment of principal on such December 1) commencing December 1, 2005. The Obligor will also pay all expenses in connection with the delivery of remarketed Bonds and with preparing a disclosure document under Section 2 hereof and will reimburse the Remarketing Agent for all of its direct out-of-pocket expenses incurred by it as Remarketing Agent or otherwise under this Agreement, including reasonable Counsel fees and disbursements.

**SECTION 5. REMARKETING AGENT NOT LIABLE FOR FAILURES BY PURCHASERS OF BONDS.** The Remarketing Agent will not be liable to the Obligor on account of the failure of any person to whom the Remarketing Agent has sold a Bond to pay for it or to deliver any document in respect of the sale.

**SECTION 6. REPRESENTATIONS AND WARRANTIES OF THE OBLIGOR.** The Obligor represents, warrants and covenants to and with the Remarketing Agent as follows:

(a) All representations and warranties of the Obligor in the Placement Agreement dated as of November 1, 2004, among the Remarketing Agent, the Issuer and the Obligor (the "Placement Agreement") are true and correct as though made at and as of the date hereof.

(b) The Obligor is fully empowered to enter into and perform all agreements on its part herein contained; the Obligor has been authorized to enter into and deliver this Agreement (by all necessary and proper legal action); and the execution and delivery by it of this Agreement and the performance of the agreements herein contained do not contravene or constitute a default under any agreement, indenture, mortgage, loan agreement, commitment, provision of its charter documents, or other existing requirements of law or regulation or any other agreement of any kind to which it is a party or by which it is or may be bound.

SECTION 7. TERMINATION. This Agreement will terminate upon the effective resignation or removal of the Remarketing Agent as Remarketing Agent in accordance with Section 911 of the Indenture. The Remarketing Agent will resign as Remarketing Agent under this Agreement if requested by the Obligor in writing upon 30 days' prior written notice. Following termination, the provisions of Section 3 will continue in effect, and each party will pay the other any amounts owing at the time of termination.

SECTION 8. MISCELLANEOUS.

(a) This Agreement will be governed by the laws of the State of Mississippi.

(b) Notices will be given to the following addresses until a party designates a new address in writing:

**If to the Obligor:**

Priority Fulfillment Services, Inc.  
500 N. Central Expressway, Suite 500  
Plano, Texas 75074

Attn: Thomas J. Madden

**If to the Remarketing Agent:**

Comerica Securities  
201 W. Fort Street  
3rd Floor  
Detroit, MI 48226-3089  
Attn: Institutional Sales

(c) Nothing contained in this Agreement shall be deemed to create any employment relationship between the parties hereto or to create any fiduciary obligations of the Remarketing Agent to the Obligor except as expressly provided herein.

(d) This Agreement may be amended from time to time by an instrument in writing executed by the parties hereto.

(e) Section headings are included herein for convenience of reference only and shall not be considered a part of this Agreement for any purpose.

(f) Any provision of this Agreement which is prohibited or unenforceable in any jurisdiction shall, as to such jurisdiction, be ineffective to the extent of such prohibition or unenforceability without invalidating any other provision hereof, and any such prohibition or unenforceability in any jurisdiction shall not invalidate or render unenforceable such provision in any other jurisdiction.

(g) The Remarketing Agent, in its individual capacity, may in good faith buy, sell, own, hold or deal in any of the Bonds, including Bonds which are remarketed, and may join in any action which any Bondholder may be entitled to take with like effect as if it did not act in any capacity hereunder. The Remarketing Agent, in its individual capacity, either as principal or agent, may also engage or be interested in any financial or other transaction with the Issuer or Obligor but it is understood and agreed that funds for the purchase of Bonds which are remarketed shall come only from the purchasers of Bonds which are remarketed or from the Obligor (including pursuant to any Credit Facility or Substitute Credit Facility) and not from the Remarketing Agent.

(h) This Agreement may be executed in any number of counterparts, all of which shall be deemed originals hereof.

**[THE BALANCE OF THIS PAGE INTENTIONALLY LEFT BLANK.  
SIGNATURE PAGE TO FOLLOW.]**

**COMERICA SECURITIES**

"Remarketing Agent"

By: \_\_\_\_\_

Michael J. Wilk  
Its:Managing Director

**PRIORITY FULFILLMENT SERVICES, INC.**

"Obligor"

By: \_\_\_\_\_

Thomas J. Madden  
Its:Chief Financial Officer



**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors  
PFSweb, Inc.:

We consent to incorporation by reference in the registration statements (Nos. 333-75764, 333-75772, 333-40020, 333-42186 and 333-46096) on Form S-8 and (No. 333-110853) on Form S-3 of PFSweb, Inc. of our report dated February 17, 2005, except for Notes 3 and 4 as to which the date is March 29, 2005, with respect to the consolidated balance sheets of PFSweb, Inc. and subsidiaries as of December 31, 2004 and 2003, and the related consolidated statements of operations, shareholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2004 and the accompanying financial statement schedules as of December 31, 2004 and 2003 and for each of the years in the three-year period ended December 31, 2004, which report appears in the December 31, 2004, annual report on Form 10-K of PFSweb, Inc.

**KPMG LLP**

Dallas, Texas  
March 29, 2005





**CERTIFICATIONS OF PRINCIPAL EXECUTIVE OFFICER  
PURSUANT TO 18 U.S.C. SECTION 1350**

I, Mark Layton, certify that:

1. I have reviewed this annual report on Form 10-K of PFSweb, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the periods covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operation and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize, and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 31, 2005

By: /s/ Mark C. Layton  
Chief Executive Officer



**CERTIFICATIONS OF PRINCIPAL EXECUTIVE OFFICER  
PURSUANT TO 18 U.S.C. SECTION 1350**

I, Tom Madden, certify that:

1. I have reviewed this annual report on Form 10-K of PFSweb, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the periods covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operation and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize, and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 31, 2005

By: /s/ Thomas J. Madden  
Chief Financial Officer



CERTIFICATIONS PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906  
OF THE SARBANES-OXLEY ACT OF 2002

Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code), each of the undersigned officers of PFSweb, Inc. (the "Company"), does hereby certify that:

The Annual Report on Form 10-K for the year ended December 31, 2004 (the "Form 10-K") of the Company fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934 and the information contained in the Form 10-K fairly presents, in all material respects, the financial condition and results of operations of the Company as of, and for, the periods presented in the Form 10-K.

March 31, 2005

/s/ Mark C. Layton

Mark C. Layton  
Chief Executive Officer

March 31, 2005

/s/ Thomas J. Madden

Thomas J. Madden  
Chief Financial Officer

The foregoing certification is being furnished as an exhibit to the Form 10-K pursuant to Item 601(b)(32) of Regulation S-K and Section 906 of the Sarbanes-Oxley Act of 2002 (subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code) and, accordingly, is not being filed as part of the Form 10-K for purposes of Section 18 of the Securities Exchange Act of 1934, as whether made before or after the date hereof, regardless of any general incorporation language in such filing.

A signed original of this written statement required by Section 906 has been provided to PFSweb, Inc. and will be retained by PFSweb, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.