

**ROBB EVANS**  
**Receiver of**  
**D.W. Heath & Associates, Inc.;**  
**PCM Fixed Income Fund I, LLC;**  
**Private Capital Management, Inc.;**  
**Private Collateral Management, Inc., et al.**

**REPORT OF RECEIVER'S ACTIVITIES**  
**JULY 12, 2004 THROUGH DECEMBER 31, 2004**

This is the third report to the Court. The purpose of this report is to:

- Provide additional financial and investor information.
- Provide a current summary of major issues confronted by the receivership estate.
- Seek approval to commence a claims administration procedure.

This report does not constitute an audit of the financial condition of the receivership; it is intended only for the information of the Court and should not be relied upon for other purposes.

### **Overview**

During the period covered by this report the Receiver<sup>1</sup> has continued the following activities that were initiated in a prior reporting period:

- Contacting, interviewing, and conducting depositions of owners and/or operators of businesses and inspecting properties in which Daniel W. Heath (Heath) placed investor funds to determine how funds were spent by these businesses and what cash flow, if any, was generated from the funds loaned to these businesses.
- Evaluating the value of the businesses and properties in which Heath invested and negotiating with certain business to maximize a return on the investment to the receivership estate.

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<sup>1</sup> Reference to the Receiver in this report means the Receiver, the Receiver's deputies, his staff, and his counsel.

- Reconstructing the financial history of Heath's entities and entities that are closely related to or jointly owned through Larre Schlarmann (Schlarmann).
- Maintaining and updating the investor and investment data on the Receiver's database that was consolidated from three databases maintained by Heath and Schlarmann.
- Communicating with investors.

## **The Intertwined Relationship of Heath, Private Capital Management, Inc. (PCM), other Heath Entities, Schlarmann and Schlarmann Entities**

As more fully described in prior reports, Heath raised investor money through a web of entities and bank accounts. Often funds were placed directly with entities controlled by Heath and Schlarmann together or individually. Heath would raise additional funds through PCM and then send the funds raised by PCM to entities that he and/or Schlarmann controlled in order to pay expenses, including investor interest payments. Heath and Schlarmann, or their owned entities, share or shared ownership of many of the assets described in more detail later in this report.

### **Investor Liability and Data from the Databases**

The Receiver has now consolidated three databases maintained by Heath and Schlarmann. Based on the consolidation of these databases the Receiver has determined that 1,692 investors are owed about \$118 million.

The Receiver has determined that the non-PCM note investments never had positive cash flow. Therefore, the Receiver has preliminarily determined that those investors who received payments in the form of interest or return of capital on non-PCM notes received those payments from funds that were invested in PCM notes. For example, the Receiver has reconciled about \$11.2 million in PCM investor funds that were paid to the Northwoods Resort account for further distribution to Northwood's investors and that about \$3.6 million in PCM investor funds were paid through the Quiznos entities for further distribution to Quiznos' investors.

### **Valuation of Recoverable Assets**

#### Real Estate Assets

There is real property held personally by the defendants that is not subject to the receivership but is subject to an Asset Freeze obtained by the Securities and Exchange Commission or the Riverside County District Attorney.

The individually owned real property may also be subject to claims by spouses or others and is the subject of discussions between the parties, the Receiver, and other potential claimants, including the Chapter 7 Trustee in Leslee Heath's<sup>2</sup> bankruptcy, which is discussed in more detail below. At this time, it is not possible to determine the net realizable value of these personal assets for the receivership estate.

### Business Investments and Assets

As discussed in more detail in previous reports, the Receiver assembled information about investments made and assets held by Heath and Schlarman through discovery, review of files and documents seized or turned over by accountants and others, interviews with accountants and former staff, and review and reconstruction of multiple bank accounts. The following paragraphs describe the major business assets and their expected recoverable value.

### **Prestige Resort Development, LLC (PRD) \$22 million disbursed by PCM & TITL**

PRD was the developer of a fractional ownership resort known as The Club at Big Bear Village located at 4067 Village Drive, Big Bear, California. The Club is a luxurious, gated residence club and high-end resort, with a total of 180 fractional units in 18 residences. The project was planned, and the drawings and site work are complete, for a total of 540 fractional units in 54 residences. 56 fractional units have been sold.

The total use of victim funds in The Club at Big Bear Village, including money TITL received from the sale of Aquatic Rehab, is \$25.34 million. With the construction loan proceeds, PRD has caused about \$42.5 million to be spent on The Club development project.

The project required substantial immediate cash needs for PRD and the Home Owners Association plus substantial amounts due for construction already completed or required. Additionally, millions of dollars were required to continue the project. The Receiver determined that the estate did not have sufficient cash to fund the project and furthermore could not risk any estate assets on a possible return several years away.

The Receiver recommended and, with this Court's approval, negotiated an agreement with the project's construction lender. The agreement provided for the lender to pay the Receivership \$725,000 and grant an interest in the project's future profits, if any. The Receiver agreed not to object to a foreclosure action by the construction lender.

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<sup>2</sup> Leslee Heath is Heath's wife

**Hotel Management, Inc. (HMI) \$13.6 million disbursed by PCM**

Previously the Receiver described Hotel Management, Inc. as the General Partner and 1.5% owner of Northwoods Resort Holdings, LP (Northwoods), which operates Northwoods Resort Hotel and Conference Center located in Big Bear, CA. The hotel has 148 rooms and a complete conference center. The Agreement of Limited Partnership shows the ownership of Northwoods as:

Limited Partners

NADM Equities, L. P.	38%
TITL Equities, L. P.	38%
Thomas A. Johnson	12.5%
Barney Family Trust	10%
Total Limited Ownership	98.5%

General Partner

Hotel Management, Inc.	1.5%
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The shareholders of the General Partner are Schlarmann 45%, Heath 45%, and Sharre Schlarmann 10%. The Barney Family Trust has abandoned its 10% limited partnership share. Thomas A. Johnson (Johnson), through his company, The Alderwood Group, has been the manager of the hotel under a management contract dated August 1, 1999.

The documented and verified use of victim funds to purchase, develop, and operate the hotel, and to pay interest to earlier investors, is \$35.1 million. The November 30, 2004 Balance Sheet of Northwoods carries total assets of \$15.0 million centered in land and buildings. There is no outside debt except current liabilities of \$627,000. Without the interest expense previously funded by PCM, the hotel has been operating at a break-even rate with about 45% occupancy. In earlier years, before the series of natural disasters in the Big Bear area, operations were profitable with an occupancy rate of about 55%.

The Receiver is in the process of reviewing appraisals, brokers' opinions of value and consultant evaluations to determine the value of the hotel property. There has been unsolicited offers from several potential buyers. If a successful sales contract can be negotiated with the potential buyer, the Receiver will seek this Court's approval to sell the property.

**Quiznos related entities \$11.6 million disbursed by PCM**

The Receiver has had numerous conversations and meetings with the management company that oversees the accounting for the franchises and with attorneys and executives from the corporate headquarters of Quiznos.

The focus of these conversations and meetings has been an analysis of the operations of the stores and projected franchise sales prices, funding and ownership problems. A number of matters remain unresolved, but all parties are working together with the objective of continuing an orderly sale of the stores to new owners.

This Court approved the appointment of a State Court Receiver as discussed in the second report. The State Court Receiver obtained approval from the Superior Court for an orderly sale of 31 Quiznos stores owned by the receivership defendants. To date, nine stores have been sold resulting in net proceeds of about \$1.3 million. Another seven stores are under a letter of intent for sale or are in escrow.

At the time of the State Court appointment, there was about \$362,350 in delinquent sales taxes owed to the State of California Board of Equalization and there was insufficient cash flow to keep sales taxes current. Therefore, the Receiver arranged a borrowing line from Quiznos Corporation and issued a receiver's certificate in the amount of \$175,000<sup>3</sup>. The Receiver borrowed about \$50,000, which has since been repaid. No further borrowings will be necessary. All delinquent sales taxes have been paid from the proceeds of the sales of the stores.

QSD Development and QIE Development are two entities in which Schlarmann has ownership interests. These entities are called area directorships and receive revenues from the royalties generated within the region of the area directorship. Royalties are based on store revenue. The Receiver is currently analyzing the value of the area directorships.

Shortly after the State Court appointment, the Receiver took steps to implement expense reductions in the area directorship operations. The staffing was dramatically reduced and the operations were moved to more economical premises. The combined reductions should produce annual savings of about \$400,000.

**Mastermind Distribution, Inc. (MD) and related entities \$8.2 million disbursed by PCM & TITL**

MD's six-month interim profit and loss statement for the period ending June 30, 2004 reported total revenues of \$402,000 and net operating losses of \$635,000. The balance sheet on the same date showed total assets of \$855,000, and notes payable to PCM of \$7.74 million, resulting in negative equity of \$7.28 million. TITL Equities, LLP owns 50% of this company.

The Receiver met with the two executives who were operating the company until September 2004 to determine the status of the company and as to the prospects for repayment of this loan.

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<sup>3</sup> This borrowing was approved by the Superior Court.

The executives advised that the company had to be shut down, due to negative cash flow and intense pressure from creditors including the landlord. They further alleged that the president of the company could not be contacted. The Receiver's attempts to meet with the president of the company, Mr. Kareem Campbell, have not been successful. A demand was sent to the last known counsel for the company and also to the last known counsel for Mr. Campbell, but the Receiver was advised that they no longer represented those clients. The Receiver is still attempting to obtain complete information as to the ownership of the registered trademarks, which appear to be the only assets of value.

The Receiver is evaluating legal options to effectively pursue the company and/or its principals, but does not expect any significant recovery on this investment.

### **Fitness Care, Inc. (FCI) and related entities \$5.3 million disbursed by PCM**

As previously reported, FCI operated as a start-up incubator to acquire, restructure, and spin off companies, which included the following:

Valley of the Sun Cosmetics  
Magnum Sports International  
Novelties USA  
TechNiGlove, Intl.

The Receiver met with the President of FCI, James Sullivan, Jr. Mr. Sullivan explained that FCI was organized to manufacture and sell neoprene sports products. Later, the company switched to manufacturing and distributing rubber balls.

FCI purchased the rights to distribute products with the Voit trademark. A small portion of the rubber ball inventory remains and the Receiver is overseeing the sale. The Receiver will hold any net proceeds. As to the possibility of repayment of the \$5.2 million, the Receiver anticipates that most of this investment is lost. The funds were used to pay salaries, expenses, production costs, and overhead, and the company never operated at a profit. Lawsuits have been filed against the company for non-payment of equipment leases and the company has vacated its business premises. Other than the inventory, which is being sold, and the distribution rights identified above, the only assets are a car and some office equipment.

The Receiver is awaiting receipt of approximately \$35,000 from a recently completed inventory sale. The disposition of the remaining inventory may collect an additional \$10,000 to \$15,000.

FCI also spent substantial funds organizing a Mexican subsidiary, Polygama, to manufacture rubber balls. Proceeds from sales of Polygama products have not yet been accounted for.

FCI's accounting records do not show receipt of any proceeds of sales. The Receiver is continuing to investigate the Polygama investment and the disposition of funds received by Polygama.

**TechNiGlove International, Inc. (TI) \$2.7 million disbursed by PCM**

TI was incorporated on July 1, 1998. This was another company funded by Heath that received substantial and ongoing funding with no written agreement and no time frame for repayment of the loans. The directors were Janine Gass, Heath, and James Sullivan, Jr. (President of FCI). The officers were Roger Gass, president, Janine Gass, secretary, and Heath, chief financial officer. After the death of Roger Gass, his wife Janine Gass took control of the company in late 2002.

TI manufactures industrial high-grade latex gloves for export to North America, Japan, and Europe. TI has an interest in a subsidiary company, Flexitech, located in Malaysia. TI has indicated it hopes to be in a position to repay the loan if Flexitech goes public and is listed on the Singapore stock exchange. To date, that has not occurred and the Receiver intends to proceed against TI for repayment of the loan. Mrs. Gass has refused to sign a personal guarantee for repayment of these business loans, but the company remains in business.

**Kenneth Hafker-Hafker Drywall, Inc. (HD) \$2.1 million disbursed by PCM & TITL**

The Receiver met with Kenneth Hafker to determine the status of the company and the prospects for repayment of this loan. The Receiver has also subpoenaed certain financial information to verify the amount due and to reconcile that amount with the amount shown on the books and records of HD. Mr. Hafker told the Receiver that he has shut down this business and cancelled all jobs in progress. The Receiver is investigating the value of the current accounts receivable and whether there are any funds remaining to be collected that could be used to satisfy part of the loan amount. Mr. Hafker has indicated that all funds have been spent and that no additional funds are due the company. Mr. Hafker was unwilling to sign a personal guarantee for repayment of this business loan and prospects for recovery of the \$2.1 million loaned to Hafker Drywall are slim, unless additional accounts receivable due the company are located.

**Bear Manor \$2.1 million raised from investors**

Bear Manor is located just west of the Big Bear Lake village in Big Bear City, California. The property consists of 15 rental cabins, each about 375 square feet, an office, and a residential building zoned for motel use. The land area is 69,696 square feet. The total assessed value of the property is \$859,444, as of the 2003 county assessment. The Receiver is expecting to obtain a current appraisal very soon.

TITL Equities LP and NADM Equities LP, which acquired the property from Bear Manor, Inc., currently hold joint title to the property. A search of corporate records nationwide reveals no corporation with the name Bear Manor, Inc.

The property was originally acquired on September 23, 1988 by Daniel and Leslee Heath and has transferred ownership a number of times. The operator and proposed purchaser of the motel reports an average 54% occupancy rate for the months of November and December 2004 and January 2005.

Before the Court Order appointing the Receiver, the record owners executed a sale agreement with the operator. The purchase price was \$1,150,000 with the seller providing financing of \$862,000 for five years with a 30 year amortization. The buyer is now arranging his own financing and the Receiver is waiting for an appraisal to confirm the validity of the sale price. Under the previous agreement, the buyer is remitting monthly payments of \$9,104.17 to the Receiver until the sale is completed.

**Valley of the Sun Cosmetics (VSC) \$1.67 million disbursed by PCM & TITL**

As previously reported, this company was spun off by FCI in late 2003 and is no longer operating in its original form. Two former employees formed Valley of the Sun Cosmetics LLC (VSC LLC) and borrowed an additional \$315,000 from Heath in the year 2004. This Court approved a settlement agreement with the principals of VSC LLC, which resulted in a payment to the estate of \$150,000.

**Design Solutions, Inc. \$1.06 million disbursed by PCM**

The company designs circuit boards and reportedly has creditworthy national companies as customers. The company is contesting at least one half of the debt claiming that Heath failed to fulfill his obligations for additional funding. The company has threatened to file for Chapter 11 bankruptcy protection. The Receiver is continuing negotiations toward a satisfactory resolution.

**Integrated Financial Company / Surgery Pro \$954,010 disbursed by PCM**

Heath was the 100% owner of Integrated Financial and Integrated Financial was the 60% owner of Surgery Pro LLC. A group of doctors hold a 40% ownership of the LLC. Surgery Pro is out of business. There are residual accounts receivable that have been assigned to a collection agency and one remaining piece of equipment. According to the manager overseeing the collection agency, the Receiver should anticipate a return on this investment of not greater than \$300,000.

**CSI Technologies, Inc. (CSI) \$872,500 disbursed by PCM and TITL**

The Receiver met with Mr. James Keaton, the President of CSI. CSI was a printed circuit board manufacturer that ceased operations in July 2003 after two secured creditors repossessed equipment and seized receivables.

Mr. Keaton acknowledged the receipt of \$872,500 from Heath entities. The funds were initially booked as loans but were converted to equity as the financial condition of the company deteriorated. This was done verbally with the intention of documenting the transaction at a later date.

The funds were used to inject cash into the company and prepare for a merger with another Heath debtor, Design Solutions, Inc. Discussions with Design Solutions deteriorated and the proposed merger was rescinded. Shortly thereafter, CSI ceased operations.

No recovery is anticipated on the loans.

**Progressive Rehab, Inc. \$792,102 disbursed by PCM**

**Lone Star Family Health, Inc. \$241,254 disbursed by PCM**

These companies are no longer operating. A Texas entity was collecting the residual accounts receivable, but that function is now being performed by a Los Angeles company. The Receiver was informed that there are approximately \$1.4 million in receivables dating from 1995 to May 2003. The collection agency is estimating a 15% to 20% recovery. All net collections will be turned over to the Receiver.

**Direct PT, National Nursing & Rehab, Restorative Health Care, UHC,  
\$909,282.66 disbursed by PCM**

The Receiver negotiated a full and immediate repayment of the amounts loaned to these four entities by PCM in exchange for the release of the stock owned by Heath and PCM in these entities. The Court has approved this transaction and payment in full is expected by January 31, 2005. The total recovery will be \$909,282.66.

**Physical Therapy Dynamics /Aquatic Rehab \$762,792 disbursed by PCM**

Heath invested in this company in partnership with Sullivan in 1991. This was a profitable business and in April, 2003 it was sold to Rivien Health Aquatic Inc. As set out below, Heath's company, TITL, received substantial proceeds from the sale. Heath's ownership share of Aquatic Rehab was 50%.

The Aquatic Rehab companies, Physical Therapy Dynamics, Inc. and Centre for Hand Therapy Inc., were sold on April 30, 2003 to Rivien Health Aquatic, Inc.

The sale price was \$37,810,998, payable \$20,000,000 in cash at closing, a non-compete agreement for \$500,000 payable annually over five years, and a note for \$17,310,998. The terms and the current status of the note are discussed in the following paragraph. After paying bonuses and commissions of about \$1.8 million, taxes of \$3.4 million, closing expenses of \$600,000, and \$1.0 million to Sullivan's Charitable Remainder Unitrust, Sullivan received \$6.7 million and Heath received \$6.5 million.

In June of 2004 the buyer asserted that business problems caused by changes in the California workers' compensation reimbursement rates and practices made the business worthless. The buyer sought a deferral of payments on the promissory note. The selling group filed an action to recover the unpaid balance of the note and the buyers counterclaimed to recover all previous payments. During a recent mediation, Rivien and Aquatic Rehab, the litigation parties, agreed to drop all claims against each other and execute full general mutual releases. As a result, there will be no additional payments to anyone from the note and any possible receivership claim against the note has no value. When the parties finalize their settlement agreement, the Receiver will seek approval from this Court to abandon the claim. Several checks totaling about \$450,000, representing Heath's principal and interest payments and non-compete payments under the terms of the sales contract, were previously forwarded to the Receiver and are being held in a trust account.

#### **The Pearson Property \$675,000 disbursed by Prestige Resort Development, LLC**

PRD purchased this property in June 2003 for \$675,000. It was to be the last four-unit building in The Club at Big Bear Village, a fractional ownership development project described earlier in this report. Since the purchase, the property has been vacant and the improvements are in fair to poor condition.

The site includes 10,454 square feet, with a 67-foot frontage on Village Drive in the Village area of Big Bear Lake, oriented to tourist retail and the surrounding residential neighborhood. The property is improved with two structures built in 1949 and 1970. The improvements total 4,482 square feet and are divided into about 50% retail, 30% residential and 20% storage. The buildings cannot be rented in their present condition.

The property may be useful to a future owner of The Club resort, or to a developer. The Receiver is obtaining appraisals and other valuations for the property. Currently, seller financing with a balance of \$252,500 has matured and is past due. The Receiver is working out a resolution with the note holder. At this time, the possible net realizable value is unknown.

### **Coast Energy Management (Coast) \$500,000 disbursed by PCM**

As previously reported, documentation provided by the SEC revealed two notes to Heath and Associates from Coast, totaling \$500,000. \$220,000 is secured by a blanket UCC filing on accounts receivable and inventory and \$280,000 is unsecured. Heath sued the company in April 2004 for defaulting on the notes.

Litigation was pending in the Superior Court of Maricopa County, Arizona, based on defaults under the notes. On November 5, 2004, both Coast and the guarantor, Daniel Bach, filed for Chapter 11 protection. A report from Coast is due to the Bankruptcy Court on January 14, 2005. The Receiver will be in a better position to evaluate recovery after reviewing the report.

### **The BikeBoard Company LLC (BB) \$399,800 disbursed by PCM and TITL**

BB was formed in December 2003 in California. Mr. Walter Stender was the president and chief financial officer and Rick Caparole was the secretary. While the entire operating capital in cash (\$399,800) was funded between December 2003 and April 2004, the actual ownership was in dispute. The principals advised in July 2004 that the company was being shut down. The Receiver concluded negotiations with the principals and a third party buyer who offered to settle the debt with the Receiver at a discount.

This Court approved a settlement agreement with the principals of BB, which resulted in a payment to the estate of \$60,000.

### **Investor Claims Procedure**

With this Court's approval, the Receiver intends to initiate a claims procedure during the first quarter of 2005<sup>4</sup>. The Receiver believes that sufficient assets will be available to make an initial distribution to investors by June 30, 2005, assuming a claims procedure has been approved and implemented by that time.

It is recommended that all distributions be made on a pro rata basis based on the adjusted claim balance. Pro rata means the ratio that the amount of the approved investor claim bears to the total amount of all investor claims.

Adjustment is appropriate to place investors on an equitable basis with one another. The adjustments should produce an account balance reflecting the investor's actual out-of-pocket loss.

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<sup>4</sup> The proposed claims procedure is generally described in this report. The details of the proposed claims procedure are more particularly set forth in the motion which seeks approval of this report and implementation of such procedures.

This loss is the total amount of the investor's actual investment, less any returns or distributions the investor received from any source. A key element is the adjustment for payments labeled as interest. Despite whatever agreements or documents exist, there were no actual payments of interest, but rather a payment of funds belonging to earlier investors or an artificial credit to accounts. Therefore, upon Court approval of this report:

- Payments of interest will be treated as a return of capital and accounts reduced accordingly.
- Payments stated as interest and credited to accounts will be reversed.
- In the case of payments for other purposes, such as partial withdrawals of amounts invested, those payments shall be treated as a return of capital and accounts reduced accordingly.

The investors will be advised of their adjusted claim amounts. Investors will be given 30 days to object to their adjusted claim amounts. In the event the Receiver is not able to resolve a disputed claim, the Receiver will present the disputed claim to this Court for a final determination.

The adjusted balance will be considered as the approved investor claim amount, upon which distributions will be based. That will also be the basis of establishing a total of approved investor claims against the estate.

Prior to making a recommendation to this Court requesting approval for an initial distribution, it will be necessary to complete a claims process. That process cannot commence until procedures are approved and implemented. Once the claims process is completed, the Receiver will make a formal distribution recommendation to the Court.

### ***Projected Recovery***

Currently, the Receiver estimates that the minimum recovery from the liquidation of the various business assets in this estate and companion State Court receivership estate will be about \$16 million. However, until several large assets are sold, the Receiver cannot estimate a more specific recovery amount. The Receiver is hopeful a projected recovery amount can be estimated by June 30, 2005.

## **Other Issues**

### Leslee Heath's Bankruptcy

Heath's wife, Leslee Heath, filed a Chapter 7 petition in bankruptcy on July 15, 2004 in Riverside Bankruptcy Court. Leslee Heath listed numerous assets on her bankruptcy schedules which the Receiver contends are properly assets of the receivership estate. The Receiver has entered into a comprehensive stipulation with the Chapter 7 Trustee, subject to this Court's approval, to provide an orderly mechanism for the administration and liquidation of the assets in which the Chapter 7 Trustee may assert an interest and the Receiver also asserts an interest. This stipulation will be presented for Court approval in January 2005. It generally provides for the Chapter 7 Trustee to administer and liquidate the three parcels of real estate held in the individual names of Heath and Leslee Heath and for the Receiver to administer and liquidate all of the other real and personal property interests directly or indirectly held by Heath and more particularly described in this report. Both the Receiver and the Chapter 7 Trustee reserve their rights to assert an interest in all of the assets and their proceeds, regardless of whether they are administered and liquidated by the Receiver or the Chapter 7 Trustee. Any dispute as to the allocation of proceeds between the estates will be presented to this Court for resolution.

### The State Court Receivership

The Receiver has reached a verbal agreement with the Riverside District Attorney's Office and Schlarmann's attorney to have the State Court receivership placed under this Court's control. The Receiver believes a consolidation of the two receiverships will result in efficiencies and reduced expenses to the overall estate. A stipulated agreement is currently under review by Schlarmann's attorney.

Respectfully submitted,

Robb Evans  
Receiver