PALLET MANAGEMENT SYSTEMS INC
Form 10-Q
February 19, 2002

U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the thirteen-week period ended
December 29, 2001
Commission File Number 000-24405

PALLET MANAGEMENT SYSTEMS, INC.
(Exact name of registrant as specified in its charter)

Florida	59-2197020
(State or other jurisdiction of incorporation)	(IRS Employer Identification Number)

2855 University Drive, Suite 510, Coral Springs, Florida 33065
(Address of principal executive offices)

Registrant's telephone number, including area code:
(954) 340-1290

(Former name or address if changed since last report)

Indicate by 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 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 X No ___

On February 11, 2002, the Registrant had outstanding 4,187,612 shares of common stock, $.001 par value.

PALLET MANAGEMENT SYSTEMS, INC.
CONSOLIDATED BALANCE SHEETS

	December 29, 2001 (unaudited)
ASSETS	

CURRENT ASSETS	
Cash	$ 212,745
Accounts receivable - trade, net of allowance for doubtful accounts	$ 3,059,725
Inventories	$ 1,766,443
Other Current Assets	$ 310,772
Total current assets	$ 5,349,685
Property and equipment - net of accumulated depreciation	$ 5,328,990
OTHER ASSETS	$ 98,433
Total assets	$ 10,777,108
LIABILITIES AND STOCKHOLDERS' EQUITY	
CURRENT LIABILITIES	
Current maturities of long-term debt	$ 618,725
Current portion of capital lease obligations	$ 124,178
Accounts payable	$ 2,820,276
Accrued liabilities	$ 381,755
Total current liabilities	$ 3,944,934
LONG-TERM DEBT	
Long-term debt	$ 3,674,996
Capital lease obligations	$ 120,666
Total long-term liabilities	$ 3,795,662
Total liabilities	$ 7,740,596
STOCKHOLDERS' EQUITY	
Preferred stock, authorized 7,500,000 shares at $.001 par value; no shares issued and outstanding Common stock, authorized 10,000,000 shares at $.001 par value; issued and outstanding 4,187,612 shares at December 29, 2001 and 4,065,612 shares at June 30, 2001	$ 4,188
Additional paid in capital	$ 7,148,592
Accumulated deficit	$ (3,978,268)
Notes receivable from stockholders	$ (138,000)
Total stockholders' equity	$ 3,036,512
Total liabilities and stockholders' equity	$ 10,777,108

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

PALLET MANAGEMENT SYSTEMS, INC.
CONSOLIDATED STATEMENT OF OPERATIONS
(Unaudited)

	13 Weeks Ended Dec. 29, 2001	13 Weeks Ended Dec. 30, 2000
Net sales	$ 15,734,615	$ 21,609,517
Cost of goods sold	$ 14,520,867	$ 20,006,231
Gross profit	$ 1,213,748	$ 1,603,286
Selling, general and administrative expense	$ 879,975	$ 1,154,265
Operating profit (loss)	$ 333,773	$ 449,021
Other income (expense)		
Other income (expense)	$ 34,415	$ (33,665)
Interest expense	$ (90,647)	$ (158,956))
Total other income (expense)	$ (56,232)	$ (192,621))
Income (loss) before income tax expense	$ 277,541	$ 256,400
Income tax expense (benefit)	$ --	$ --
Net income (loss)	$ 277,541	$ 256,400
Net earnings (loss) per common share	$ 0.07	$ 0.06
Diluted earnings (loss) per common share	$ 0.07	$ 0.06

* exercise of warrants and options would be anti-dilutive

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

PALLET MANAGEMENT SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	26 Wks Ended Dec. 29, 2001
Cash flows from operating activities:	
Net income (loss)	$ (202,096)
Adjustments to reconcile net income (loss) to net cash provided by/(used in) operating activities:	
Depreciation	$ 351,767
Stock Options issued for Services	$ 17,158
(Increase) Decrease in operating assets:	
Accounts receivable	$ 1,554,887
Inventories	$ 275,046
Other assets	$ (58,559)
Increase (Decrease) in operating liabilities:	
Accounts payable	$ (219,289)
Accrued liabilities	$ (128,197)
Net cash provided by/(used in) operating activities	$ 1,590,717
Cash flows from investing activities:	
Other assets	$ --
Purchase of fixed assets	$ (80,587)
Proceeds from Disposal of fixed assets	$ 40,184
Net cash used in investing activities	$ (40,403)
Cash flows from financing activities:	
Net Borrowings from lenders	$ --
Net Payments of long-term debt	$(1,570,204)
Net cash provided by/(used in) financing activities	$(1,570,204)
Increase/(Decrease) in cash	$ (19,890)
Cash at beginning of period	$ 232,635
Cash at end of period	$ 212,745

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Pallet Management Systems, Inc.
Notes to Financial Statements
December 29, 2001

Note 1. Consolidated Financial Statements:

The consolidated balance sheet as of December 29, 2001, the consolidated statements of operations and cash flows for the twenty-six week period ended December 29, 2001 and twenty-seven week period ended December 30, 2000 and consolidated statements of operations for the thirteen week periods ending December 29, 2001 and December 30, 2000 have been prepared by the Company without audit in accordance with generally accepted accounting principles for interim financial information and with instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments necessary to present fairly the financial position, results of operations and cash flows for the periods reported have been made. Operating results for the twenty-six weeks ended December 29, 2001 are not necessarily indicative of the results that may be expected for the year ended June 29, 2002. These consolidated financial statements should be read in conjunction with the financial statements and the notes thereto included in the Company's annual report filed on Form 10-K as of June 30, 2001.

Certain prior year amounts within the accompanying financial statements have been reclassified to conform to the current period presentation.

Note 2. Debt Agreement

The Company has a revolving loan and three term loans with La Salle Business Credit in a three year agreement, which commenced April 14, 2000. As of December 29, 2001 the Company was in full compliance with all loan covenants.

Advances under the revolving agreement are based on the sum of 85% of eligible accounts receivable, plus the lesser of 55% of eligible inventories or $2,500,000. Interest is paid monthly at the bank's prime rate plus one percentage point. Principal is due in April 2003, with possible year to year renewals thereafter. The revolving agreement is collateralized by substantially all of the assets of the Company. At December 29, 2001, the Company had $2,260,000 of availability under the revolving agreement.

The three term loans as of December 29, 2001 were at $1,157,000, $1,387,000 and $ 945,000. These loans are collateralized by substantially all the assets of the Company.

Note 3. Inventories

Inventories consisted of the following at December 29, 2001:

Raw material	$ 1,112,534
Work in process	$ 503,637
Finished goods	$ 150,272
TOTAL	$ 1,766,443

Note 4. Net Earnings (Loss) per Share of Common Stock:

Net earnings (loss) per share of common stock was determined by dividing net income (loss) applicable to common shares by the weighted average number of common shares outstanding during each period. Diluted earnings/(loss) per common share reflects the potential dilution that could occur assuming exercise of all issued and unexercised stock options. A reconciliation of the net income/(loss) and numbers of shares used in computing basic and diluted earnings/(loss) per common share is as follows (in thousands, except per share data):

	26 Weeks Ended December 29 2001	27 Weeks Ended December 30 2000
Basic earnings/(loss) per common share:		
Net income/(loss)	($ 202)	$ 311
Weighted average common shares outstanding for the period	4,071	4,065
Basic earnings per share of common stock	($ 0.05)	$ 0.08
Diluted earnings/(loss) per common share:		
Net income/(loss)	($ 202)	$ 311
Weighted average common shares outstanding for the period	4,071	4,065
Increase in shares which would result from exercise of stock options	*	317
Weighted average common shares, assuming conversion of the above securities	*	4,382
Diluted earnings/(loss) per share of common stock	*	0.07

* exercise of warrants and options would be anti-dilutive

Note 5. Litigation

In June 1999, the Company was named as a co-defendant in a lawsuit whereby the plaintiff is alleging damages of up to $300,000 related to lost income from a facility and other property formerly leased to the Company in Jessup, Maryland. Management believes the claim is without merit and intends to vigorously contest the claim. St. Paul Insurance is currently paying defense costs. The outcome of the action as well as the extent of the Company's liability, if any, can not be determined at this time.

Note 6. Revenue Recognition

Sales revenue is generally recorded upon the delivery of goods or the acceptance of goods by the customer according to contractual terms and represents amounts realized, net of discounts and allowances.

Note 7. Accounting for Software Related Costs

The Company accounts for the costs of computer software developed or obtained for internal use in accordance with Statement of Position 98-1 which generally requires the capitalization of costs incurred during the application development stage of computer software meeting certain characteristics. All costs incurred during the preliminary project stage and post implementation / operation stage are expensed as incurred.

Note 8. New Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 141, "Business Combinations" (SFAS 141), which applies to all business combinations initiated after June 30, 2001. This statement requires that all business combinations be accounted for by the purchase method and defines the criteria used to identify intangible assets to be recognized apart from goodwill.

In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" (SFAS 142), which is effective for fiscal years beginning after December 15, 2001, except goodwill and intangible assets acquired after June 30, 2001 are subject immediately to the non-amortization and amortization provisions of this Statement. Under the new rules, goodwill and intangible assets deemed to have indefinite lives will no longer be amortized but will be subject to annual impairment tests in accordance with the Statement. Other intangible assets will continue to be amortized over their useful lives.

In August 2001, the Financial Accounting Standards Board Issued Statement of Financial Accounting Standards No. 143, "Accounting for Asset Retirement Obligations", effective for fiscal years beginning after June 15, 2002. This statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated retirement costs.

In October 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-lived Assets", effective for fiscal years beginning after December 15, 2001. This statement addresses financial accounting and reporting for the impairment or disposal of long-lived assets.

The Company has not yet determined what the effects of these Statements will be on its financial position and results of operations.

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Note 9. Stockholders' Equity

In October 2001, the Company granted options to purchase approximately 660,000 shares of common stock to employees and directors of which 280,000 were granted to the President. 460,000 of these options vested upon grant while the remainder vest through July 1, 2006.

In December 2001, the President of the Company exercised options to acquire 280,000 shares of common stock through the transfer of 88,000 mature shares. Upon exercise, the President was granted "reload" options to acquire 88,000 shares of common stock at $1.75 per share. These transactions are currently under review by the Company.

Also in December 2001, the President transferred 70,000 shares of common stock to the Company in satisfaction of his note payable to the Company in the amount of $138,000, as permitted by the original terms of the note.

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PART I

ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operation

The following discussion and analysis should be read in conjunction with the financial statements appearing as Item 1 to this Report and the Form 10-K for the year ended June 30, 2001. The financial statements in this Report reflect the consolidated operations of Pallet Management Systems, Inc. (the "Company" or "Pallet Management") for the thirteen-week and twenty-six-week periods ended December 29, 2001 and for the thirteen-week and twenty-seven week periods ended December 30, 2000.

The following discussion regarding Pallet Management and its business and operations contains "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. These statements consist of any statement other than a recitation of historical fact and can be identified by the use of forward-looking terminology such as "may," "expect," "anticipate," "estimate" or "continue" or the negative thereof or other variations thereon or comparable terminology. The reader is cautioned that all forward-looking statements are necessarily speculative and there are certain risks and uncertainties that could cause actual events or results to differ materially from those referred to in such forward-looking statements, including the limited history of profitable operations, dependence on CHEP, competition, risks related to acquisitions, difficulties in managing growth, dependence on key personnel and other factors discussed under "Risk Factors" in the Annual Report on Form 10-K for the year ended June 30, 2001. Pallet Management does not have a policy of updating or revising forward-looking statements and thus it should not be assumed that silence by management of Pallet Management over time means that actual events are bearing out as estimated in such forward-looking statements.

Results of Operations

General

Pallet Management has grown to be one of the largest pallet companies in the estimated $6 billion U.S. pallet industry, by providing value-added products and services to our customers. Our customer base has remained stable.

The majority of our revenues have traditionally been generated from providing high quality, specially engineered pallets to manufacturers, wholesalers and distributors. As supply chain logistics have become increasingly complex, our existing customers as well as prospective customers are seeking new ways to streamline distribution and reduce costs, which is opening a service-orientated market for us.

With this shift in focus toward services and cost efficiency, we are providing "state of the art" logistical services known as reverse logistics. Reverse logistics is simply defined as maximizing the use of transport packaging, the base of which is the pallet, by reusing assets to reduce the overall cost per trip.

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This shift in focus toward supply chain efficiency by our customer base is by far our industry's most dramatic shift in focus and provides the most opportunity for our company. Driven mainly by economics, reusable packaging in a reverse logistics system also has environmental marketing benefits.

Reverse logistics, a sub-industry of the logistics industry, is growing rapidly and is estimated to have reached $7.7 billion. The third-party logistics industry is estimated to be in excess of $35 billion and growing rapidly as companies are discovering the benefits of outsourcing their logistical demands.

The Company has two lines of revenue, manufacturing and services:

Manufacturing: Our Company has two primary categories of manufacturing: CHEP grocery pallets and specifically engineered niche market pallets. The Company has multi-year contracts to manufacture high quality grocery pallets for CHEP, the world's largest pallet rental pool. The Company is currently operating two manufacturing facilities, which currently produce CHEP pallets; Bolingbrook, Illinois and Plainfield, Indiana. In Rogersville, Alabama, our contract expired on September 7th, 2001. The Company is currently winding down operations and is closing the facility in fiscal year 2002. In Bolingbrook, Illinois, our contract expires on April 30th, 2002 and in Plainfield, Indiana, our contract expires on March 1, 2003. The Company expects to close the Bolingbrook, Illinois facility before the end of this fiscal year.

Pallets that are specially engineered to transport a specific product are classified as niche market pallets. Besides CHEP, our Company's customer base is primarily composed of customers who require niche pallets. Niche pallets are lower volume and higher margin than CHEP pallets.

Pallet Management functions as a wholesale distributor of other various returnable transport packaging such as plastic and metal pallets; collapsible plastic bulk boxes; wood, plastic, and metal slave pallets; wooden boxes and crates; and various other products. Due to lack of demand, sales of pallets made from materials other than wood are minimal.

Services: Our Company provides a variety of retrieval, sortation, repair, warehouse and return services that enable our customers to better utilize their packaging assets. Besides being environmentally friendly, a properly repaired used pallet will provide the customer significant savings over having to buy a new pallet. Despite recent increases in levels of automation, pallet return operations remain a labor-intensive process.

Pallet users currently discard a large portion of new pallets after one use. The condition and size of these pallets vary greatly. The pallets are sorted and repaired as needed, placed in storage and made available for return to service. Pallets that can be repaired have their damaged boards replaced with salvaged boards or boards from new stock inventoried at the facility.

Pallets that cannot be repaired are dismantled and the salvageable boards are recovered for use in repairing and building other pallets. Pallet Management sells the remaining damaged boards to be ground into wood fiber, which is used as landscaping mulch, fuel, animal bedding, gardening material and other items.

As part of the Company's strategy to use the Internet to improve the effectiveness of its service offerings, it developed PalletNetTM , a service brand providing a logistics and information system that manages the flow of shipping platforms and containers throughout industrial supply chains (excluding the grocery industry). PalletNetTM creates a closed loop delivery, recovery and recycling system, which enables customers to treat pallets as assets rather than variable cost consumables.

The principal services PalletNetTM offers include reverse distribution, single source national contracts, high quality shipping platforms and transport packaging, recovery, repair, recycling and export packaging. These physical activities are supported by leading edge technology that enables users to improve shipping asset controls and reduce cost and waste from the supply chain, while reducing inventories and enhancing customer satisfaction. By coupling PalletNetTM with the Internet, the Company is creating value for the customer through substantially lower costs and improved efficiencies.

The PalletNetTM Application is an Internet Explorer browser-based user interface which delivers secure access to customers who can view exactly where their shipping platforms and containers are in the supply chain at any given moment. PalletNetTM has the capability to use information from either bar codes or radio frequency identification tags to track individual pallets and the equipment transported on them. These new logistical and information systems provide customers and Pallet Management the technical support requirements to manage an efficient reverse distribution operation and the management of valuable transport packaging from one location to another.

Pallet Management has hired key sales personnel during this fiscal year to expand its service offerings and service revenues. Until the newly hired sales personnel are trained, there will be an increase in the Selling, General and Administrative expenses as a percentage of sales. In addition, the cycle for completing a sale of services is significantly longer than that for selling manufactured pallets. We anticipate that service will become a greater percent of net sales as our new sales force begins to move forward.

Thirteen Weeks Ended December 29, 2001 compared to Thirteen Weeks Ended December 30, 2000

For the thirteen-week period ended December 29, 2001, net sales decreased 27% to $ 15,735,000 from $ 21,610,000 for the comparable fiscal year 2001 period. This decrease is primarily due to the second quarter closing of our Alabama facility whose sales were reduced $ 4,554,000 from the comparable period in fiscal year 2001, as well as reduced demand for niche pallets from the Lawrenceville, Virginia facility.

During the thirteen-week period ended December 29, 2001, manufacturing sales decreased 28% to $ 15,245,000 from $ 21,099,000. The decrease in manufacturing sales was primarily due to the reduction of orders received by our

major customer at our Alabama facility, as well as a general slow down of orders received in the niche pallet sales at the Lawrenceville, Virginia location. The Alabama facility was closed in September 2001 and generated only runoff sales of $36,000 during the thirteen-week period ending December 29, 2001 as compared to $4,590,000 in the comparable period from fiscal year 2001.

Service sales decreased by 4% to $ 490,000 from $ 511,000. This slight decrease in service sales is primarily due to the reduction of repair services made at the Petersburg, Virginia facility as a result of reduced demand from the facility's key customer.

Pallet Management had a 24% reduction in its selling, general and administrative expenses from $ 1,154,000 to $ 880,000 for the thirteen-week period ended December 29, 2001 when compared to the thirteen-week period ended December 30, 2000. The decrease in selling, general and administrative expenses is primarily due to the reduction of consulting expense. This reduction was made as we currently have full time employees handling the workload that consultants previously provided, causing a reduction to overall expenses by approximately $100,000. Selling, general and administrative expenses were also reduced by the initiative of the company to hold down costs for travel, telephone and legal expenses. Additionally, we had increased premiums for our insurance in fiscal year 2001, which were favorably re-negotiated for fiscal year 2002.

A net income of $ 278,000 or $.07 per share was realized during this thirteen-week period ended December 29, 2001 compared to a net income of $256,000 or $.06 per share recorded for the thirteen-week period last fiscal year. Compared to the same period last year, we were able to increase profitability on less sales due to operational and management improvements, as well as reducing our selling, general and administrative expenses associated with consulting as described above. In addition, we had a decrease in interest expense by approximately $ 68,000 caused by a lower effective interest rate on our loans and by effective cash management. Pallet Management anticipates that the third quarter will slow in demand from our largest customer as well as from our niche pallet customers. With our controlled cost measures still in place, and by operating under strict budget guidelines, we are working on reducing the impact to income that these reduced demands may cause.

Twenty-six Weeks Ended December 29, 2001 compared to Twenty-seven Weeks Ended December 30, 2000

For the twenty-six week period ended December 29, 2001, net sales decreased 30% to $ 28,695,000 from $ 41,083,000 for the twenty-seven week period ended December 30, 2000. This decrease is primarily due to the reduction in orders from our Alabama facility, which was closed in September 2001. For the twenty-six week period ending December 29, 2001, the Alabama sales decreased to $ 1,274,000 from $ 9,558,000 for the twenty-seven week period ending December 30, 2000, an 87% reduction.

During the twenty-six-week period ended December 29, 2001, manufacturing sales decreased 30% to $ 27,816,000 from $ 39,985,000 for the twenty-seven week period ended December 30, 2000. The decrease in manufacturing

sales was primarily due to the Alabama facility closing as described above, as well as, reduced orders from our Illinois facility during our first quarter as our primary customer changed its ordering to a just in time philosophy and reduced its overall demand. The Illinois facility had reduced sales over the prior year by $ 2,324,000. In addition to the above, we have not increased our niche/specialty pallet sales from our Lawrenceville, Virginia facility. That facility showed fewer sales over the prior year by $ 2,213,000 caused by a softening market as our customers look to hold down costs and reduce expenditures. We have brought on additional sales persons in the first half of this fiscal year in an effort to bolster these declining sales from our Virginia facility.

Service sales decreased by 20% to $ 879,000 from the $ 1,098,000 recorded for the twenty-seven week period ended December 30, 2000. The decrease in services is primarily due to the reduction of repair services made at the Petersburg, Virginia facility as a result of reduced demand from the facility's key customer.

We experienced a 23% decrease in selling, general and administrative expenses from $ 2,203,000 to $ 1,701,000 for the twenty-six week period ended December 29, 2001 when compared to the twenty-seven week period ended December 30, 2000. The decrease in selling, general and administrative expenses is primarily due to the reduction of consulting expense. This reduction was made as we currently have full time employees handling the workload that consultants previously provided, causing a reduction to overall expenses by approximately

$200,000. Selling, general and administrative expenses were also reduced by the initiative of the company to hold down costs for travel, telephone and legal expenses. Additionally, we had increased premiums for our insurance in fiscal year 2001, which were favorably re-negotiated for fiscal year 2002.

A net loss of ($ 202,000) or ($ 0.05) per share was recorded during this twenty-six week period ended December 29, 2001 compared to a net income of $311,000 or $0.08 per share recorded for the twenty-seven week period ended December 30, 2000. During the twenty-seven week period ended December 30, 2000 we had introduced new management and had consistent sales from our customer base. The new management team streamlined processes and created opportunities for profit. As that period ended and throughout the calendar year 2001, sales from our facilities in Alabama and Lawrenceville, Virginia declined. During the twenty-six week period ending December 29, 2001 the Alabama facility had a drop off in sales of $ 8,284,000 and the Lawrenceville facility had a drop off in sales of $ 2,213,000 as compared to the twenty-seven week period ending December 20, 2001. This reduction in sales caused by the plant closings and the weak economy contributed to our year to date loss. In addition, we had a decrease in interest expense by approximately $84,000 over the prior year caused by a lower effective interest rate on our loans and by effective cash management. As we entered this fiscal year, we sought and hired new sales persons to increase sales and profitability. We anticipate growing our customer base and diversifying our sales throughout the remainder of the fiscal year.

Liquidity and Capital Resources

Pallet Management Systems had $213,000 cash on hand at December 29, 2001, versus $233,000 at the beginning of the fiscal year. The slight decrease in cash is primarily attributed to the timing of our payables and receivables, as well as the year to date net loss as of December 29, 2001. The cash used in financing activities is primarily due to repayments on the revolver and term loans to LaSalle Business Credit ($1,536,000). Net cash provided by operating activities of $ 1,591,000 is primarily due to a decrease in our accounts receivables balance of $ 1,555,000 due to the lower balance associated with our primary customer in December 2001 as compared with June 2001 primarily caused by the Alabama facility closing. Additionally, inventory decreased by $275,000 primarily due the reduction of inventory from our Alabama facility and an effort to reduce inventory as we approached January 2002, which we anticipate having a lower order rate, and therefore, a lower required inventory level.

The Company believes that existing cash on hand, cash provided by future operations including PalletNetTM services, additional available borrowings under its current line of credit, and a net working capital of $1,405,000 as of December 29, 2001, will be sufficient to finance its operations and expected working capital and capital expenditure requirements for the remainder of this fiscal year.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

In June 1999, the Company was named as a co-defendant in a lawsuit whereby the plaintiff is alleging damages of up to $300,000 related to lost income from a facility and other property formerly leased to the Company in Jessup, Maryland. Management believes the claim is without merit and intends to vigorously contest the claim. St. Paul Insurance is currently paying defense costs. The outcome of the action as well as the extent of the Company's liability, if any, can not be determined at this time.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned thereunto duly authorized.

PALLET MANAGEMENT SYSTEMS, INC.

Dated: February 19, 2002 By: /s/ John C. Lucy III

John C. Lucy III, Chief Executive Officer

Dated: February 19, 2002 By: /s/ Marc S. Steinberg

Marc S. Steinberg, Chief Financial Officer