

TRI-S SECURITY CORP  
Form 10-Q  
May 15, 2009  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

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

**For the quarterly period ended March 31, 2009**

**.. TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT**

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number 0-51148**

**TRI-S SECURITY CORPORATION**

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

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**GEORGIA**  
(State or other jurisdiction of

**30-0016962**  
(I.R.S. Employer

incorporation or organization)

Identification No.)

**11675 Great Oaks Way, Suite 120, Alpharetta, Georgia 30022**

(Address of principal executive offices)

**(678) 808-1540**

(Registrant's telephone number, including area code)

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 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 check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act) Yes  No

Shares of the registrant's common stock, par value \$0.001 per share, outstanding as of May 14, 2009: 4,203,280.

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**QUARTERLY REPORT ON FORM 10-Q FOR THE**  
**QUARTER ENDED MARCH 31, 2009**

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**Table of Contents****Tri-S Security Corporation and Subsidiaries****Consolidated Balance Sheets****Unaudited****(In thousands, except per share data)**

	March 31, 2009	December 31, 2008
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 15,426	\$ 12,465
Unbilled revenues and trade accounts receivable	775	676
Prepaid expenses and other assets	7,389	9,028
Assets held for sale		
<b>Total current assets</b>	<b>23,590</b>	<b>22,591</b>
Property and equipment, less accumulated depreciation	664	597
Goodwill	7,747	7,747
Intangibles, net		
Customer contracts		22
Deferred loan costs	695	797
Other		6
<b>Total assets</b>	<b>\$ 32,696</b>	<b>\$ 31,760</b>
<b>Liabilities and Stockholders Deficit</b>		
Current liabilities:		
Bank overdraft	\$ 85	\$ 1,556
Trade accounts payable	1,932	1,315
Other accrued expenses	476	534
Accrued interest expense - short term	946	5,134
Accrued salary and benefits	6,765	67
Income taxes payable	59	15,775
Asset-based lending facility	18,984	1,025
10% convertible notes	900	5,480
Liabilities held for sale	4,632	
<b>Total current liabilities</b>	<b>34,779</b>	<b>30,886</b>
Other liabilities:		
14% convertible notes	6,607	6,470
Term loan	2,500	2,500
Accrued interest expense - long term	259	277
Series D preferred stock subject to mandatory redemption	1,500	1,500
<b>Total liabilities</b>	<b>45,645</b>	<b>41,633</b>
Stockholders' deficit:		
Common stock, \$0.001 par value, 25,000,000 shares authorized; 4,248,704 shares issued at March 31, 2009 and December 31, 2008	4	4
Treasury stock - 45,424 shares at cost	(105)	(105)
Additional paid-in capital	17,705	17,562
Deficit	(30,553)	(27,334)

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Total stockholders' deficit	(12,949)	(9,873)
Total liabilities and stockholders' deficit	\$ 32,696	\$ 31,760

See accompanying notes to financial statements.

**Table of Contents****Tri-S Security Corporation and Subsidiaries****Consolidated Statements of Operations****Unaudited****(In thousands, except per share data)**

	<b>Three Months Ended March 31,</b>	
	<b>2009</b>	<b>2008</b>
Revenues	\$ 29,322	\$ 16,291
Cost of revenues		
Direct labor	18,473	9,896
Indirect labor and other support costs	9,929	5,626
Amortization of customer contracts	23	67
	28,425	15,589
Gross profit	897	702
Selling, general and administrative	2,043	1,690
Amortization of intangible assets	118	163
	2,161	1,853
Operating loss	(1,264)	(1,151)
Other income (expense):		
Interest expense	(1,384)	(765)
Other income	5	5
	(1,379)	(760)
Loss before income taxes	(2,643)	(1,911)
Income tax expense	2	47
Net loss from continuing operations	(2,645)	(1,958)
Loss from discontinued operations, net of tax	(574)	(171)
Net loss	\$ (3,219)	\$ (2,129)
Basic and diluted net loss per common share continuing operations	\$ (0.63)	\$ (0.47)
Basic and diluted net loss per common share discontinued operations	\$ (0.14)	\$ (0.04)
Basic and diluted weighted average number of common shares	4,203	4,203

See accompanying notes to financial statements.

**Table of Contents****Tri-S Security Corporation and Subsidiaries****Consolidated Statements of Cash Flows****Unaudited****(In thousands)**

	<b>Three Months Ended March 31,</b>	
	<b>2009</b>	<b>2008</b>
Cash flow from operating activities continuing operations:		
Net loss from continuing operations	\$ (2,645)	\$ (1,958)
Adjustments to reconcile net loss from continuing operations to net cash used by operating activities:		
Depreciation and amortization	231	272
Non-cash employee stock option expense	134	365
Non-cash interest expense	12	54
Changes in operating assets and liabilities:		
Unbilled revenues and trade accounts receivable, net	(2,961)	(2,213)
Prepaid expenses and other assets	(99)	(624)
Trade accounts payable	376	85
Accrued liabilities	1,186	3,130
Income taxes payable	29	44
<b>Net cash used by operating activities</b>	<b>(3,737)</b>	<b>(845)</b>
Cash flow from investing activities continuing operations:		
Purchase of property and equipment	(158)	(384)
<b>Net cash used by investing activities</b>	<b>(158)</b>	<b>(384)</b>
Cash flow from financing activities continuing operations:		
Bank overdraft	85	
Net proceeds from borrowing facility	3,208	1,889
Deferred financing costs	(1)	(26)
<b>Net cash provided by financing activities</b>	<b>3,292</b>	<b>1,863</b>
Cash flow from discontinued operations:		
Net cash used by operating activities	(401)	(128)
Net cash provided by financing activities	582	(624)
<b>Net cash provided (used) by discontinued operations</b>	<b>181</b>	<b>(752)</b>
Net decrease in cash and cash equivalents	(422)	(118)
Cash and cash equivalents at beginning of period	422	373
<b>Cash and cash equivalents at end of period</b>	<b>\$</b>	<b>\$ 255</b>
Supplemental disclosures of cash flow information:		
Interest paid continuing operations	\$ 969	\$ 468
Interest paid discontinued operations	\$ 91	\$ 103
Income taxes paid	\$ 10	\$ 4
Tender of 10% convertible notes for 14% convertible notes	\$ 116	\$

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Payment of deferred financing costs through issuance of warrants

\$ 9 \$

See accompanying notes to financial statements.



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**TRI-S SECURITY CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**March 31, 2009**

**1. Organization**

Tri-S Security Corporation, a Georgia corporation ( Tri-S , the Company or we ), was incorporated in October 2001 under the name Diversified Security Corporation. We changed our name to Tri-S Security Corporation on August 16, 2004. We provide contract guard services to: (i) various Federal government agencies through our subsidiary, Paragon Systems, Inc., an Alabama corporation with its principal office located in Washington, DC ( Paragon Systems ), and a joint venture in which we are a 49% partner, Southeastern Paragon ( SEP ) and (ii) commercial and state and local government customers through our subsidiary, The Cornwall Group ( Cornwall ), a Florida corporation with its principal offices located in Miami, Florida.

Tri-S was formed for the purpose of acquiring and consolidating electronic and physical security companies in order to take advantage of the operating efficiencies created by a large company. Tri-S has acquired and continues to pursue acquisition opportunities in the contract guard services and system integration services segments of the security industry.

We provide cost-effective solutions to ensure the safety and security of the assets and personnel of our customers and to continually improve the protection we provide for their personnel, programs, resources and facilities. Our goal is to provide demonstrably superior contract guard services with the highest degree of integrity and responsiveness. The Company has two reportable segments: Cornwall and Paragon Systems/SEP.

In January 2006, Paragon Systems entered into a Joint Venture Agreement with Southeastern Protective Services, Inc. ( Southeastern Protective Services ) to form SEP. Paragon Systems owns 49% and Southeastern Protective Services owns 51% of SEP. SEP was formed to bid on certain contracts, and Paragon Systems will manage the contracts awarded to SEP. We are accounting for the joint venture in accordance with FASB Interpretation No. 46 (R) Variable Interest Entities because we believe that SEP is a VIE in which we are the primary beneficiary. In the first quarter of 2009, Tri-S recorded revenue from SEP of \$1.5 million.

In September, 2007, Paragon Systems formed On Duty Patrol Services LLC ( ODPS ), a joint venture between Paragon Systems and On Duty Patrol Services, Inc. ODPS has been certified by the U.S. Small Business Administration (the SBA ) as a small and disadvantaged business (an 8(a) firm ) and is therefore qualified to bid on security contracts specially designated for 8(a) firms. Paragon Systems owns 49% of ODPS. Since its formation, ODPS has not entered into any contracts.

All significant intercompany transactions have been eliminated.

**2. Basis of Presentation**

The accompanying consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States ( GAAP ). The financial statements presented are unaudited and have been prepared by our management in accordance with the rules and regulations of the Securities and Exchange Commission (the SEC ). In the opinion of our management, all adjustments, consisting of normal recurring accruals, necessary for the fair presentation of the financial position, results of operations and cash flows have been included. For further information, see our audited financial statements and footnotes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2008 (the Annual Report ) filed with the SEC. Disclosure that substantially duplicates the disclosure contained in the footnotes to the audited financial statements included in the Annual Report has been omitted from these notes.

In the first quarter of 2009, the Company approved the sale of the Cornwall business. In accordance with Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, ( SFAS No. 144 ), a business component that is disposed of or classified as held for sale is reported as discontinued operations if the cash flows of the component have been or will be eliminated from the ongoing operations of the Company, and the Company will no longer have any significant continuing involvement in the business component. The results of discontinued operations are aggregated and presented separately in the consolidated statements of operations and cash flows. Assets and liabilities of the discontinued operations are aggregated and reported separately as assets and liabilities held for sale in the consolidated balance sheet. SFAS No. 144 requires the reclassification of amounts presented for prior years to effect their classification as discontinued operations.



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Amounts related to the discontinuance have been derived from the consolidated financial statements and accounting records of the Company using the historical basis of Cornwall's assets and liabilities to be disposed of and historical results of operations. See note 5 for more information on discontinued operations.

**3. Liquidity**

The Company has historically incurred operating losses and has not yet generated sufficient levels of cash flows from operating activities to meet its scheduled debt service payments and other obligations. The Company has relied on its senior lenders, LSQ Funding Group, L.C. (LSQ) and BRE LLC (BRE and, together with LSQ, the Lenders), to fund operations in excess of the borrowing base formula. Our Lenders and the Company entered into a forbearance agreement dated December 12, 2008 that extends our forbearance agreement through January 1, 2010 and that allows for such funding over the Company's borrowing base and waives certain debt covenant defaults. If the balance outstanding under our agreements with our Lenders becomes immediately due and payable, as a result of the subjective acceleration clause or other provisions of the loan agreements, and we are unable to raise significant capital or obtain from our Lenders additional waivers or an additional forbearance agreement, then we will not be able to satisfy our obligations to our Lenders, and our Lenders may proceed to foreclose on the collateral and our business and financial condition will be materially and adversely affected.

Additionally, in November 2008, we completed our offer to exchange our outstanding 10% Convertible Promissory Notes due in 2008 (the 10% Notes) for our 14% Convertible Promissory Notes due 2010 (the New Notes) and warrants to purchase shares of our common stock (the Exchange Offer). The Exchange Offer was completed on the terms and conditions set forth in our tender offer statement on Schedule TO, initially filed with the Securities and Exchange Commission on August 20, 2008, as amended. In the Exchange Offer, approximately \$6.6 million, or 86%, of the aggregate principal amount of the 10% Notes was tendered for New Notes and warrants.

The future success of the Company is dependent upon, among other things, our ability to: achieve and maintain satisfactory levels of profitable operations; obtain and maintain adequate levels of debt and/or equity financing; and generate sufficient cash flow from operations to meet current and future debt obligations. We anticipate that, with the recently awarded contracts to Paragon Systems, the board of directors having approved initiatives to reduce expenses and the sale of our Cornwall business, along with the forbearance agreement with our Lenders, our cash flows will provide sufficient operating resources through December 31, 2009.

**4. Stock-based Compensation**

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standard No. 123 (revised 2004), *Share Based Payment* (SFAS No. 123(R)), using the modified prospective method and, therefore, reflects compensation expense in accordance with the SFAS No. 123(R) transition provisions. Under the modified prospective method, prior periods are not restated to reflect the impact of adopting the new standard at earlier dates.

In accordance with SFAS No. 123(R), the Company recorded \$134,000 and \$365,000 of stock-based compensation expense for the three months ended March 31, 2009 and 2008, respectively, related to employee stock options, restricted stock and warrants. After recording the expense through March 31, 2009, there remained approximately \$55,000 of unrecognized compensation cost related to unvested employee stock options to be recognized over the next year.

**5. Discontinued Operations**

In March 2009, the Company's board of directors determined to sell the Cornwall business. Cornwall is based in Miami, Florida and provides physical security for clients in Miami, Fort Lauderdale, and West Palm Beach, Florida. The decision to sell the Cornwall business was made so that we could focus on growing our government business and reduce our overall debt load. On May 13, 2009, the Company sold substantially all of the assets (except those accounts receivable) of Cornwall and its subsidiaries for a purchase price of \$3.6 million, of which \$750,000 will be held in escrow to secure the continuation of certain contracts transferred as part of the sale.

Revenues and loss for the discontinued operations were as follows (in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2009</b>	<b>2008</b>
Revenues	\$ 5,267	\$ 10,174

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Loss from discontinued operations, net of tax	\$	(574)	\$	(171)
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Assets and liabilities of the discontinued operations were as follows:

	March 31, 2009	December 31, 2008
<b>Assets held for sale:</b>		
Cash and cash equivalents	\$ 840	\$ 824
Restricted cash	75	75
Unbilled revenues and trade accounts receivable, net	2,859	4,145
Prepaid expenses and other assets	201	227
Property and equipment, net	10	14
Goodwill	2,078	2,078
Intangibles, net	1,326	1,665
	\$ 7,389	\$ 9,028

	March 31, 2009	December 31, 2008
<b>Liabilities held for sale:</b>		
Trade accounts payable	\$ 201	\$ 329
Other accrued expenses	701	743
Accrued salary and benefits	447	542
Asset based lending facility	3,283	3,866
	\$ 4,632	\$ 5,480

**6. Common and Preferred Stock**

Immediately prior to the initial public offering of our common stock on February 9, 2005, we entered into an exchange and recapitalization agreement with all of the holders of common stock, convertible preferred stock and holders of rights to acquire common stock. Pursuant to the agreement, we implemented a reverse stock split of all the outstanding shares of its common stock and stock options and exchanged common stock for all Series A and B Convertible Preferred Stock. The recapitalization was given retroactive treatment in the financial statements and related disclosures.

On September 13, 2007, as a result of the Settlement Agreement (the "Paragon Settlement Agreement") among Tri-S, Paragon Systems and Ronald G. Farrell, our Chief Executive Officer, and the former shareholders of Paragon Systems (the "Selling Shareholders"), we cancelled the shares of the Series C Redeemable Preferred Stock held by the Selling Shareholders. Holders of the Series C Redeemable Preferred Stock had no voting rights, except that a consent of a majority of the holders of the Series C Redeemable Preferred Stock, voting separately as a class, was required to increase or decrease the number of authorized shares of Series C Redeemable Preferred Stock and except as otherwise required by applicable law. The Series C Redeemable Preferred Stock did not have any preemptive, conversion or sinking fund rights nor did it have any rights or preferences in the event of a liquidation, dissolution or winding-up of the Company.

Also, on September 13, 2007, as a result of the Paragon Settlement Agreement, the Company issued to the Selling Shareholders an aggregate of 700,000 shares of common stock and an aggregate of 100 shares of Series D Redeemable Preferred Stock, which (a) have an aggregate redemption value of \$1,500,000, payable upon the earlier of September 13, 2012, or the date on which the Company sells 70% or more of its assets in one or more transactions (unless the proceeds from such sale are reinvested in the Company's business, used to restructure debt or used for acquisitions or working capital purposes), and (b) accrue dividends of \$750 per share per annum and are payable quarterly.

We are authorized to issue 25 million shares of common stock with a par value of \$0.001 per share. The holders of common stock are entitled to one vote per share on all matters. Our common stock does not have cumulative voting rights and has no conversion rights. Each share of common stock has an equal and ratable right to receive dividends to be paid from assets legally available when and if declared by our board of directors. We have never paid any cash dividends on common stock.

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During the first quarter of 2008, the Company granted to Mr. Farrell an option to purchase 400,000 shares of common stock at an exercise price of \$2.50 per share, which vests with respect to one-half of the underlying shares on the date of grant and the remaining one-half of the underlying shares on the first anniversary of the date of grant. Pursuant to the Paragon Settlement Agreement and concurrently with the grant to Mr. Farrell, the Company granted to the Selling Shareholders options to purchase an aggregate of 40,000 shares of common stock at an exercise price of \$2.50 per share, which options vest on the same schedule as the option granted to Mr. Farrell.

### **7. Debt and Other Obligations**

#### **Amended and Restated Credit Agreement**

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On October 18, 2005, we entered into a Credit Agreement (the Original Credit Agreement ) with our Lenders, pursuant to which we borrowed \$1,650,000 pursuant to a term loan with a maturity date of October 1, 2007 ( Term Loan A ) and \$3,500,000 pursuant to a term loan with a maturity date of October 1, 2009 ( Term Loan B ) and, together with Term Loan A, the Term Loans ). During the second quarter of 2006, the Term Loans were paid in full.

In connection with the Original Credit Agreement, we entered into a Factoring and Security Agreement (the Factoring Agreement ) with LSQ, pursuant to which LSQ purchased from us from time to time certain accounts receivable at a discount of 0.7% and provided us with a professional accounts receivable management service for a funds usage fee of the prime rate plus 1.0% on the funds advanced on the outstanding accounts receivable purchased. The Factoring Agreement had a \$6,000,000 initial purchase limit and a four-year term which automatically renewed unless we provided notice of our intent to terminate.

Pursuant to the Original Credit Agreement, we also entered into (i) a Guaranty Agreement pursuant to which we unconditionally and irrevocably guarantee to our Lenders the prompt payment and performance of all of our obligations, indebtedness and liabilities to our Lenders, whether currently existing or subsequently arising (the Obligations ); and (ii) a Security Agreement, pursuant to which we granted to our Lenders a security interest in substantially all of our assets to secure all of the Obligations. Additionally, we have entered into a Pledge Agreement pursuant to which we pledged to our Lenders the capital stock of Paragon Systems to secure all of our obligations under the Original Credit Agreement and related documents.

On June 27, 2006, Paragon Systems executed a Guaranty of Joint Venture (the JV Guaranty ) pursuant to which Paragon Systems unconditionally guarantees to LSQ the prompt payment and performance of all obligations, indebtedness and liabilities, whether currently existing or subsequently arising, of SEP (the JV Obligations ). The JV Obligations include the obligations, indebtedness and liabilities of SEP to LSQ under that certain Factoring and Security Agreement between SEP and LSQ dated as of June 27, 2006 (the JV Factoring Agreement ), pursuant to which LSQ will purchase from SEP from time to time certain accounts receivable at a discount of 0.7% and provide SEP a professional accounts receivable management service for a funds usage fee equal to the prime rate plus 1.0% on the funds advanced on the outstanding accounts receivable purchased. The JV Factoring Agreement has a \$1,000,000 initial purchase limit and a one-year term which will automatically renew unless SEP provides notice of its intent to terminate.

During March 2007, we entered into an Amendment and Forbearance Agreement with our Lenders pursuant to which we amended the Original Credit Agreement and secured an additional \$2.5 million term loan (the 2007 Term Loan ) with our Lenders to provide additional financing as needed to provide the capital we estimated was necessary to continue to operate the business during 2007. The 2007 Term Loan matures on March 28, 2010. The 2007 Term Loan bears a 0.25% per month fee on the unused portion of the loan.

On December 31, 2007, we entered into an Amended and Restated Credit Agreement (the Amended and Restated Credit Agreement ) with our Lenders, which amends and restates the Original Credit Agreement. The Amended and Restated Credit Agreement amends and restates the Original Credit Agreement to provide us with a revolving, asset-based lending facility with up to \$25.0 million of borrowing availability, replacing our pre-existing factoring facility with up to \$12.0 million of borrowing availability under the Original Credit Agreement. In connection with entering into the Amended and Restated Credit Agreement, we also entered into (i) a Loan and Security Agreement with LSQ, as may be amended from time to time (the Loan and Security Agreement ), and (ii) a Supplemental Agreement to Amended and Restated Credit Agreement with our Lenders (the Credit Agreement Supplement ).

The Amended and Restated Credit Agreement continues to provide for the \$2,500,000 2007 Term Loan contemplated by the Original Credit Agreement. Under the Amended and Restated Credit Agreement, interest on the 2007 Term Loan accrues at a rate equal to the prime rate, as published by the Wall Street Journal from time to time (the Prime Rate ), plus 4.50% (the Non-Default Rate ), but at no time shall the interest rate be less than 11.25% per annum. If an event of default under the Amended and Restated Credit Agreement occurs, then interest accrues on the 2007 Term Loan at a rate equal to the Non-Default Rate plus 5% and certain other default fees specified in the Amended and Restated Credit Agreement would become due and payable. The 2007 Term Loan requires us to pay a Minimum Balance Fee, as described in the Amended and Restated Credit Agreement, if the 2007 Term Loan is repaid prior to maturity.

Pursuant to the Loan and Security Agreement, at our request, LSQ shall make advances ( Advances ) to us not to exceed \$25,000,000 and subject to a borrowing base, which base includes 90% of accounts receivable, including unbilled accounts receivable. Prior to repayment of the 2007 Term Loan, interest accrues on Advances made on the basis of (i) billed accounts receivable at a rate equal to the Prime Rate plus 1% (but not less than 11%) and (ii) unbilled accounts receivable at a rate equal to the Prime Rate plus 4.5% (but not less than 12%). In addition, until the 2007 Term Loan is paid in full, we must pay LSQ a fee of .7% of the face amount of billed accounts receivable. Following repayment of the 2007 Term Loan, interest accrues on all Advances at a rate equal to the Prime Rate plus 4.5%. Upon the occurrence of an event of default under the Loan and Security Agreement, interest is payable on all Advances at a rate equal to the Prime Rate plus 9.5%. The Loan and Security Agreement includes a subjective acceleration clause and expires on October 31, 2010.





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Under the Credit Agreement Supplement, anytime the 2007 Term Loan is outstanding and so long as unbilled accounts receivable are included in the borrowing base for purposes of making Advances, we must pay a monthly fee to our Lenders equal to 2.25% of the highest daily overadvance amount (which is the highest daily amount in any given month calculated as the outstanding 2007 Term Loan plus all outstanding Advances less the borrowing base) less (ii) \$60,000 or such lesser amount as will reduce the overadvance fee to zero. In addition, the Credit Agreement Supplement requires that we issue to our Lenders a four-year warrant to purchase 30,000 shares of common stock, at an exercise price of \$3.00 per share, for each month in which an overadvance under the Loan and Security Agreement exists. In no event shall such warrants issued to Lenders under the Credit Agreement Supplement be exercisable in the aggregate for greater than 420,000 shares of common stock.

All of our obligations under the Amended and Restated Credit Agreement and the Loan and Security Agreement are secured by a first priority security interest in all of our assets and a pledge of all of the equity interests in our subsidiaries.

The outstanding balance under the Amended and Restated Credit Agreement as of March 31, 2009, is approximately \$25.7 million. Additionally, from time to time during 2008 and 2009, we have borrowed more than the maximum amount allowable under the availability formula under the Amended and Restated Credit Agreement. Accordingly, on those occasions when the outstanding balance exceeded the availability, we were charged the default interest and fees by our Lenders.

As of December 31, 2007, we were not in compliance with the Amended and Restated Credit Agreement and the outstanding borrowings exceeded the borrowing base as defined. On March 26, 2008, we entered into an Amendment and Forbearance Agreement, as amended from time to time (the Forbearance Agreement), with our Lenders. Pursuant to the Forbearance Agreement, our Lenders waived certain specified defaults under the Amended and Restated Credit Agreement and agreed to forbear from exercising all remedies available to them in connection with such existing defaults until the earlier of (i) a potential equity or subordinated debt offering by us or (ii) January 1, 2009. On December 12, 2008, the Forbearance Agreement was amended to extend the end of the forbearance period from January 1, 2009 to January 1, 2010.

If an event of default under the Amended and Restated Credit Agreement or any agreement we have with our Lenders occurs, then the entire balance outstanding under all such agreements shall become immediately due and payable. We will not be able to repay this balance unless we raise significant capital by selling assets or issuing debt or equity securities, which we may not be able to do on terms acceptable to us, if at all. If the balance outstanding under our agreements with our Lenders becomes immediately due and payable and we are unable to raise significant capital or obtain from our Lenders an additional waiver and an agreement to forbear, then we will not be able to satisfy our obligations to our Lenders, our Lenders may proceed to foreclose on the collateral and our business and financial condition will be materially and adversely affected.

**Convertible Notes**

During September and October 2005, we issued in a private placement transaction the 10% notes with an aggregate principal amount of \$8,015,000 and warrants to purchase 834,896 shares of common stock for a total purchase price of \$8,015,000. The 10% Notes and warrants were issued in four closings between September 2, 2005 and October 14, 2005. The face value of the 10% Notes was \$8,015,000 upon issuance. Interest is payable monthly on the face value of the 10% Notes at a rate of 10% per annum. The gross proceeds from the offering of 10% Notes and warrants was allocated to the 10% Notes and warrants in accordance with Emerging Issue Tax Force 98-5, *Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios* ( EITF 98-5 ). In accordance with EITF 98-5, \$6,107,000 of the gross proceeds was allocated to the 10% Notes and \$1,908,000 was allocated to additional paid in capital related to the warrants and the beneficial conversion feature. The conversion of the 10% Notes was restricted at the issue date because of the need for a shareholder vote to approve the contingently issuable shares as well as certain other restrictions. In February 2006, the shareholders approved the shares issuable upon conversion of the 10% Notes. Accordingly, approximately \$1.1 million of the in-the-money beneficial conversion feature was recorded to increase the book value of the 10% Notes. Of the \$1.1 million of in-the-money beneficial conversion feature, approximately \$700,000 was recorded as interest expense during the second quarter 2006 and approximately \$426,000 was recorded as a reduction to additional paid in capital because of additional conversion restrictions associated with a certain portion of the 10% Notes. During the third quarter 2007, the 10% Notes subject to conversion restrictions became convertible. Accordingly, approximately \$426,000 was recorded as interest expense and as an increase to paid in capital. The remaining discount on the 10% Notes relative to face value was amortized to interest expense over the remaining life of the 10% Notes.

The 10% Notes are convertible by the holders at an initial conversion price of \$4.80 per share subject to certain restrictions. The warrants issued in the private placement expired in September and October of 2008.

The 10% Notes with an outstanding principal balance of approximately \$7.6 million matured in September and October 2008. On November 13, 2008, we completed the Exchange Offer in which approximately \$6.6 million, or 86%, of the aggregate principal amount of the 10% Notes was tendered for new notes and warrants.



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On December 16, 2008, we issued to each of two accredited investors: (i) a promissory note with a principal amount of \$25,000, which is convertible into shares of our common stock at a conversion price of \$1.75 per share, accrues interest on the principal amount at a rate of 14% per annum and matures on November 13, 2010; and (ii) a five-year warrant to purchase 2,604 shares of our common stock at an exercise price of \$0.75 per share. Each of the investors agreed to accept the promissory note and warrant in full repayment of the 10% convertible promissory note with an outstanding principal amount of \$25,000, which matured in September 2008, previously issued by us to such investor.

On January 8, 2009, we issued to each of two accredited investors: (i) a promissory note with a principal amount of \$37,500, which is convertible into shares of our common stock at a conversion price of \$1.75 per share, accrues interest on the principal amount at a rate of 14% per annum and matures on November 13, 2010; and (ii) a five-year warrant to purchase 3,906 shares of common stock at an exercise price of \$0.95 per share. Each of the investors agreed to accept the promissory note and warrant in full repayment of the 10% convertible promissory note with an outstanding principal amount of \$37,500, which matured in October 2008, previously issued by us to such investor.

On February 3, 2009, we issued to an accredited investor: (i) a promissory note with a principal amount of \$50,000, which is convertible into shares of our common stock at a conversion price of \$1.75 per share, accrues interest on the principal amount at a rate of 14% per annum and matures on November 13, 2010; and (ii) a five-year warrant to purchase 5,208 shares of our common stock at an exercise price of \$0.75 per share. The investor agreed to accept the promissory note and warrant in full repayment of the 10% convertible promissory note with an outstanding principal amount of \$50,000, which matured in October 2008, previously issued by us to such investor.

**8. Income Taxes**

We adopted the provisions of FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No. 109* ( FIN 48 ), on January 1, 2007. FIN 48 prescribes a recognition threshold that a tax position is required to meet before being recognized in the financial statements and provides guidance on the de-recognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition issues. The adoption of FIN 48 resulted in the recognition of \$32,104 of penalties which was recorded as an adjustment to the January 1, 2007 retained earnings. No adjustments were made in the quarter ended March 31, 2009 to the balance of unrecognized tax benefits and no material change is expected in the next twelve months. In addition, the following information required by FIN 48 is provided:

As noted above, as of January 1, 2007, we have accrued penalties in the amount of \$32,104 related to uncertain tax positions. As of March 31, 2009, the total amount of interest and penalties accrued was \$185,965. Accrued interest on tax deficiencies and tax penalties are recorded as a component of income tax expense.

The recognition of unrecognized tax benefits will not impact the Company's effective tax rate.

The Company and its subsidiaries file federal income tax returns, as well as multiple state and local tax returns. The tax years of 2006 to 2008 for all jurisdictions remain open to examination.

At March 31, 2009, the Company had cumulative gross federal income tax net operating loss ( NOL ) carryforwards of approximately \$10.6 million available to reduce future amounts of taxable income, as a result of taxable losses from operations from 2007 to current. If not utilized to offset future taxable income the current NOL will expire between 2027 and 2029. Additionally, the Company acquired through the Cornwall acquisition unused federal NOLs. Under Internal Revenue Code section 382, there is an annual limitation on the use of the NOLs acquired from Cornwall. If not utilized to offset future taxable income, the cumulative NOL amount will expire from 2020 through 2025. The Company also had approximately \$945,000 of tax effected state NOLs. If not utilized to offset future state taxable income, the state NOLs will expire between 2020 and 2029. For the quarter ended March 31, 2009, management has recorded a total valuation allowance of \$1.1 million against its deferred tax assets including the NOL s.

An assessment is made at the end of each reporting period of the likelihood that the recorded net deferred tax asset will be realized. The net deferred tax asset must be reduced by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50%) that some portion or all of the new deferred tax asset will not be realized within a relatively short period, generally no more than three years. As of March 31, 2009, management recorded a total valuation allowance of approximately \$4.9 against its deferred tax assets including the NOL s.

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For the three months ended March 31, 2009 and 2008, the Company's effective tax rate was 0.0% and 2.1%, respectively. For the three months ended March 31, 2009, the principal cause of the difference between the effective rate and the U.S. statutory rate of 34% was the recording of an additional allowance of \$1.1 against the deferred tax asset.

**9. Net Loss per Share**

Basic net loss per share is computed by dividing net loss available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted net loss per share gives effect to all potentially dilutive securities. For the three

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months ended March 31, 2009 and 2008, the effect of our warrants and stock options were not included in the computation of diluted earnings per share as their effect was anti-dilutive.

**10. Related Party Transactions****Employment Agreements**

Pursuant to the employment agreement, as amended, between us and Mr. Farrell, Mr. Farrell has agreed to serve as our Chief Executive Officer and President until June 30, 2010. The agreement provides for (i) payment of a specified base salary which increases by 10% per year; (ii) payment of an annual incentive bonus equal to 5% of our earnings before interest, income taxes, depreciation and amortization, as adjusted ( EBITDA ) for such year, provided that such bonus may not exceed 100% of Mr. Farrell s base salary for such year; (iii) prohibitions against Mr. Farrell s disclosure of confidential information, solicitation of our employees and participation in a business competitive with our business during his employment and for a period of one year following the termination of his employment; and (iv) continuation of Mr. Farrell s compensation and benefits for the remainder of the term of his employment agreement if his employment is terminated by us without cause or by Mr. Farrell for good reason or upon a change of control of the Company, provided that if a change of control occurs after June 30, 2008 and before July 1, 2010, Mr. Farrell is entitled to receive all monies which he would have been paid under the employment agreement had the term the agreement terminated on the second anniversary of such change of control rather than on June 30, 2010. Pursuant to Mr. Farrell s employment agreement, we also provide certain other benefits and expense reimbursements to Mr. Farrell which are consistent with his position as our Chief Executive Officer. Mr. Farrell is also entitled to participate in any employee benefit plan, stock option plan and other fringe benefit plan at the discretion of the Board.

During 2008, the Company and Mr. Farrell agreed to amend his employment agreement as follows: (i) to reduce his annual salary by (a) 25% during the period from January 1, 2009 through June 30, 2009 and (b) 50% during the period from July 1, 2009 through June 30, 2010; and (ii) to grant to Mr. Farrell (a) 100,000 shares of common stock on the date the amendment to his employment agreement is executed and (b) 81,406 shares of common stock on January 1, 2009. Notwithstanding the foregoing, the reduction in Mr. Farrell s annual salary shall not affect the calculation of bonus, severance or other amounts which Mr. Farrell is entitled to receive, and which are calculated with reference to Mr. Farrell s base salary , under his employment agreement and such bonus, severance and other amounts will be calculated and made as if the reduction in Mr. Farrell s annual salary had not occurred. The stock grants, if made, will be made pursuant and subject to the terms and conditions of the Company s 2004 Stock Incentive Plan, as amended and restated (the Incentive Plan ).

The Company and Mr. Farrell further agreed the stock grants will vest in a manner such that an aggregate of 10,000 shares will vest on the last day of each month during the period from January 1, 2009 through May 31, 2010, and the remaining unvested shares underlying the stock grants will vest on June 30, 2010. Notwithstanding the foregoing, if the Company experiences a change in control (as defined in the Incentive Plan), or if Mr. Farrell resigns, is terminated from his position, ceases to be the Company s Chief Executive Officer or otherwise ceases to be employed by the Company, then all shares underlying the stock grants which have not vested by the end of the month in which such change in control occurs, or at the time of such resignation, termination or cessation, will be forfeited.

During 2007, the Company entered into an employment agreement with Nicolas V. Chater, pursuant to which Mr. Chater has agreed to serve as the Company s Chief Financial Officer until June 30, 2010. Pursuant to the employment agreement, the Company has agreed to pay Mr. Chater for his service as the Company s Chief Financial Officer as follows: (i) a base salary at a rate of \$250,000 per year, (ii) an annual retention bonus equal to \$25,000 per year and (iii) an annual performance bonus equal to 3% of the Company s EBITDA for such year; provided, that (a) the annual performance bonus may not exceed 100% of the base salary for such year and (b) Mr. Chater s 2008 performance bonus shall not be less than \$90,000. The employment agreement also provides that, if Mr. Chater s employment is terminated by the Company without cause or by him for good reason, then Mr. Chater shall be entitled to receive a single lump sum in an amount equal to his then-current salary and performance bonus and shall be entitled to participate in the Company s employee benefit, retirement and compensation plans during the twelve-month period following the date of such termination. Notwithstanding the foregoing, if Mr. Chater s employment is terminated by the Company without cause during the 24-month period following a change of control of the Company, then Mr. Chater will be entitled to receive a lump sum payment of his then-current performance bonus and twice his then-current base salary and shall be entitled to participate in the Company s employee benefit, retirement and compensation plans during the 24-month period following the date of such termination.

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The Company has also granted to Mr. Chater, pursuant to the Incentive Plan, an option to purchase 100,000 shares of common stock, with one-half of the underlying shares vesting on each of the first anniversary and the second anniversary of the date of grant. The option has an exercise price equal to the fair market value of our common stock on the date of grant. Subject to availability under the Incentive Plan, the Company has also agreed to grant Mr. Chater an option to purchase up to 50,000 shares of our common stock on each anniversary of the execution of the employment agreement, with such options vesting equally over a two-year period. These options will have an exercise price equal to the fair market value of our common stock on the date of grant. In November 2008, the Compensation Committee of the Board of Directors determined to grant 50,000 restricted shares of our common stock in lieu of such options.

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During the three months ended March 31, 2009 and 2008, respectively, 84.8%, and 61.5% of the Company's revenue was earned under contracts with various Federal government agencies through its Paragon Systems/SEP subsidiary. At March 31, 2009, two customers individually accounted for at least 10% of total revenue: the Department of Homeland Security - Southern California (\$7.6 million or 22% of revenue) and the Social Security Administration (\$5.4 million or 15.5% of revenue). At March 31, 2009 and 2008, approximately 84.4% and 85.5% of accounts receivable were due from various Federal government agencies, respectively.

**12. Segment Reporting**

The Company's two reportable segments are Cornwall and Paragon Systems/SEP. The accounting policies applicable to these reportable segments are the same as those described in the summary of significant accounting policies. The Cornwall segment focuses on contract guard services to commercial and state and local government customers. The Paragon Systems/SEP segment focuses on contract guard services to various Federal government agencies.

We considered our organization and reporting structure and the information used by our chief operating decision makers to make decisions about resource allocation and performance assessment and determined management evaluates the performance of the segments based primarily on revenues and operating income (loss). Revenues, operating income, and assets for each segment are as follows (in thousands):

	Total	Discontinued operations - Cornwall	Paragon Systems/SEP	Other
<b>For the three months ended March 31, 2009</b>				
Revenues	\$ 29,322	\$	\$ 29,322	\$
Amortization and depreciation	231		117	114
Operating loss	(1,264)		(156)	(1,108)
Interest expense, net	1,384		350	1,034
Loss from discontinued operations, net of tax	(574)	(574)		
Current assets	23,590	7,389	16,110	91
Goodwill	7,747		7,747	
Other intangibles	695			695
Total assets	32,696	7,389	24,488	819

	Total	Discontinued operations - Cornwall	Paragon Systems/SEP	Other
<b>For the three months ended March 31, 2008</b>				
Revenues	\$ 16,291	\$	\$ 16,291	\$
Amortization and depreciation	270		129	141
Operating loss	(1,151)		87	(1,238)
Interest expense, net	765		122	643
Loss from discontinued segment, net of tax	(171)	(171)		
Current assets	29,066	17,373	11,669	24
Goodwill	7,747		7,747	
Other intangibles	667		287	380
Total assets	38,101	17,373	20,276	452

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the Management's Discussion and Analysis of Financial Condition and Results of Operations contained in the Annual Report.

You should carefully review the information contained in this Quarterly Report and should particularly consider any risks and other factors that we set forth in this Quarterly Report and in other reports or documents that we file from time to time with the SEC. Except for historical information contained herein, this Quarterly Report contains forward-looking statements within the meaning of Section 27A of the Securities



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Act and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act ), including statements of our expectations as to future events and our future financial performance. In some cases, you can identify those so-called forward-looking statements by words such as may, will, should, expects, plans, anticipates, believes,

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estimates, predicts, potential, or continue or the negative of those words and other comparable words. You should be aware that those statements are only our predictions, which are being made as of the date hereof. Actual events or results may differ materially. In evaluating those statements, you should specifically consider various factors, including those outlined below. Those factors may cause our actual results to differ materially from any of our forward-looking statements. We undertake no obligation to update any forward-looking statements, whether as a result of new information, future events or otherwise.

### **Overview**

We provide contract guard services to government and commercial customers. These guard services include providing uniformed and armed guards for access control, personnel protection, plant security, theft prevention, surveillance, vehicular and foot patrol, crowd control and prevention of sabotage, terrorist and criminal activities. In connection with providing these services, we assume responsibility for a variety of functions, including recruiting, hiring, training and supervising security guards deployed to the customers we serve as well as paying all guards and providing them with uniforms, employee benefits and workers compensation insurance. We are responsible for preventing the interruption of guard services as a consequence of illness, vacations or resignations.

### **Critical Accounting Policies**

The following discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with GAAP. The preparation of these financial statements requires us to make judgments regarding estimates that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures. We base our judgments on historical experience and on various assumptions that we believe are reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. We believe our judgments and related estimates regarding the following accounting policies are critical in the preparation of our consolidated financial statements.

**Revenue Recognition.** Revenue is recorded monthly as guard services are provided to our customers under contracts. We bill guard services in arrears at hourly or monthly rates based on the number of hours worked under some contracts and at fixed monthly amounts under other contracts. Hourly and monthly rates are based on contractual terms.

The terms of our contracts are complex and may be subject to differing interpretations. We make estimates and judgments about terms of the contracts in providing services and in billing and recording revenue. At times, our Federal contracts require interpretations. Typically, differences in interpretation are resolved on a mutual basis in discussions with the government agency involved. The resolution of differences may result in a determination that amounts previously billed are not in accordance with contract terms and adjustments of amounts initially recorded as revenue may be material.

Contracts with Federal government agencies may be subject to cessation of funding. Cessation of funding may result in amounts billed and recorded as revenue as being uncollectible. We work with the appropriate government agency to resolve funding issues. When funding issues become known, we make estimates and judgments about the extent of potential losses and adjust revenues accordingly. Amounts estimated could differ from amounts ultimately collected and these amounts could be material. During 2008, 2007 and 2006, none of our contracts have been subject to cessation of funding.

Contract losses, if any, are recorded as they become known.

**Cost of Revenues.** Cost of revenues is primarily comprised of labor, related payroll taxes, employee benefits, workers compensation, liability insurance, and the pro rata portion of the costs of customer contracts acquired.

We make estimates and judgments of amounts recorded for accruals of labor related costs. Expenses most subject to estimation and judgment are accrued vacation and workers compensation costs. The terms of vacation policies may be complex and subject to interpretation. Workers compensation insurance is subject to retroactive audit. Actual amounts could differ from the amounts initially recorded.

**Impairment of Long-lived Assets, Goodwill and Intangible Assets.** We evaluate impairment of long-lived assets, including property and equipment and intangible assets with finite lives, whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. If the sum of the expected future undiscounted cash flows is less than the carrying amount of the asset, then an impairment loss is recognized. Measurement of an impairment loss for long-lived assets is based on discounted cash flows and the fair value of an asset.

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**SFAS No. 123(R).** On January 1, 2006, we adopted SFAS No. 123R (revised 2004), *Share-Based Payment* ( SFAS No. 123R ), using the modified-prospective-transition approach method. Under this transition method, compensation costs for 2006 include costs for options, restricted stock and warrants granted prior to, but not vested at, December 31, 2005, and options vested thereafter. Therefore, results for prior periods have not been restated.

### **Results of Operations - Three Months Ended March 31, 2009 Compared to Three Months Ended March 31, 2008**

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*Revenue.* Revenue increased \$13.0 million to \$29.3 million, or 80.0%, for the three months ended March 31, 2009, as compared to revenue of \$16.3 million for the three months ended March 31, 2008. The increase in revenue is primarily due to five new federal government contracts obtained by Paragon Systems, net of four contract expirations.

*Costs of Revenues.* We categorize our cost of revenues into three areas: (i) direct labor; (ii) indirect labor and other contract support costs; and (iii) amortization of government contracts.

*Direct Labor.* Direct labor is the most significant expense in providing guard services on any contract. Direct labor was approximately 63.0% of revenue in 2009 and 60.7% of revenue in 2008. When bidding on contracts, we must anticipate labor rates during the contract term.

*Indirect Labor and Other Contract Support Costs.* This category of expenses consists primarily of indirect labor (guard supervisors), our portion of payroll taxes, employee benefit costs and other expenses. Other expenses comprise a relatively small portion of costs in this category. As with direct labor, when bidding on contracts, we must anticipate the cost of providing supervisory oversight of the guards performing the actual guard services and the related payroll taxes and employee benefits that are provided to both guards and supervisors. Indirect labor and other contract support costs were approximately 33.9% of revenue in 2009 and 34.5% of revenue in 2008.

*Amortization of Government Contracts.* Upon our acquisition of each of Paragon Systems and Cornwall, the existing contracts were valued in accordance with purchase accounting rules and the resulting asset values are being amortized over the remaining term of each contract proportionate to estimated future discounted cash flows based on an independent appraisal.

*Total Cost of Revenue.* Our total cost of revenue, as a percentage of revenue, was 96.9% in 2009 and 95.7% in 2008.

*Selling, General and Administrative Expense.* Selling, general and administrative expenses as a percentage of revenue was 7.0% in 2009 and 10.4% in 2008. Selling, general and administrative expenses, which include payroll and related expenses for administrative personnel, occupancy costs at the office locations, consulting and professional fees, and other miscellaneous office and corporation expenses, increased \$353,000 to \$2.0 million, or 20.9%, for the three months ended March 31, 2009, as compared to \$1.7 million for the three months ended March 31, 2008. This increase is primarily due to higher bank fees associated with higher revenue, and increased personnel costs to support the growth in business.

*Interest Expense, Net.* Interest expense relates to the interest incurred on our Loan and Security Agreement, the 2007 Term Loan and the interest expense incurred on our 10% and 14% convertible promissory notes. Interest expense increased \$619,000, or 80.9%, to \$1.4 million for the three months ended March 31, 2009, as compared to interest expense of \$765,000 for the three months ended March 31, 2008. The increase is primarily due to higher outstanding balances on our Loan and Security Agreement in 2009.

*Income Tax Expense (Benefit).* The loss before income taxes for the three months ended March 31, 2009, resulted in tax expense of \$2,000. The loss before income taxes for the three months ended March 31, 2008, resulted in tax expense of \$47,000.

## **Liquidity and Capital Resources**

As of March 31, 2009, we had a zero cash balance. For the three months ended March 31, 2009, cash used by operating activities was \$3.7 million primarily due to the net loss from continuing operations of \$2.6 million, which included depreciation and amortization of \$231,000, and the increase of unbilled revenues and trade accounts receivable of \$2.9 million, partially offset by the increase in accrued liabilities of \$1.2 million. Cash provided by financing activities was \$3.2 million primarily due to the proceeds from our asset-based lending facility.

The outstanding balance under the Amended and Restated Credit Agreement as of March 31, 2009, is approximately \$25.7 million, which includes \$3.3 million attributable to discontinued operations. Additionally, from time to time during 2008 and 2009, we have borrowed more than the maximum amount allowable under the availability formula under the Amended and Restated Credit Agreement. Accordingly, on those occasions when the outstanding balance exceeded the availability, we were charged the default interest and fees by our Lenders.

As of December 31, 2007, we were not in compliance with the Amended and Restated Credit Agreement and the outstanding borrowings exceeded the borrowing base as defined. On March 26, 2008, we entered into the Forbearance Agreement with our Lenders. Pursuant to the Forbearance Agreement, our Lenders waived certain specified defaults under the Amended and Restated Credit Agreement and agreed to forebear from exercising all remedies available to our Lenders in connection with such existing defaults until the earlier of a potential equity or subordinated debt offering or January 1, 2009. On December 12, 2008, the Forbearance Agreement was amended to extend the end of the Forbearance period from January 1, 2009 to January 1, 2010.

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We have historically incurred losses and has not yet generated sufficient levels of cash flows from operating activities to meet our scheduled debt service payments and other obligations. On November 13, 2008, we completed the Exchange Offer pursuant to

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which we exchanged approximately \$6.5 million, or 86%, of the aggregate principal amount of our outstanding 10% convertible promissory notes for our 14% convertible promissory notes and warrants.

The future success of the Company is dependent upon, among other things, our ability to: achieve and maintain satisfactory levels of profitable operations; obtain and maintain adequate levels of debt and/or equity financing; and provide sufficient cash flow from operations to meet current and future obligations. We anticipate the recently awarded contracts along with the initiatives instituted to maximize cash flows and raise additional equity will alleviate any short-term liquidity issues facing us and will contribute toward achieving profitability and positive cash flow.

### **Item 4T. Controls and Procedures**

In connection with preparing Form 10Q/A for the quarter ended March 31, 2008, our Chief Executive Officer and Chief Financial Officer evaluated our disclosure controls and procedures as of the end of the period covered by the Quarterly Report and concluded that such disclosure controls and procedures were ineffective due to the material weakness that we identified in our internal control over financial reporting in that we did not maintain effective controls over the completeness and accuracy of certain accrued liabilities and related expense accounts with respect to payroll. Specifically, effective controls which were designed and in place to ensure the complete and accurate recording of accrued liabilities and related expenses at each period end with respect to payroll were not followed. A further discussion of this material weakness is set forth under Item 9(a), Controls and Procedures, of our Annual Report on Form 10-K for the year ended December 31, 2008.

Our Chief Executive Officer and Chief Financial Officer again have evaluated our disclosure controls and procedures pursuant to Rule 13a-15 under the Exchange Act as of March 31, 2009. Based on such evaluation, such officers have concluded that, as of March 31, 2009, our disclosure controls and procedures are effective.

There were no changes in our internal control over financial reporting that occurred during the first quarter of 2009 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **PART II - OTHER INFORMATION**

### **Item 1. Legal Proceedings**

Except as set forth in our Annual Report, and as discussed below, we believe that, based on currently known facts, there are no claims or litigation pending against us the disposition of which would materially affect our financial position or future operating results, although we cannot be certain as to the ultimate outcome of any such claim or litigation. In addition, exposure to litigation is inherent in our ongoing business and may harm our business in the future.

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**Litigation Regarding Our Initial Public Offering**

As previously disclosed, on November 1, 2006, a purported class action complaint was filed in the State Court of Fulton County, State of Georgia, against Tri-S, its Chief Executive Officer, its former Chief Financial Officer and the lead underwriters in Tri-S's initial public offering, alleging, among other things, violations of Sections 11, 12(a)(2) and 15 of the Securities Act of 1933, as amended, in connection with Tri-S's initial public offering (*Unschuld v. Tri-S Security Corp., et al.*, the Unschuld Litigation). More specifically, the complaint alleges that the registration statement relating to the initial public offering was materially inaccurate and misleading because it failed to disclose certain problems with the operations and financial condition of Paragon Systems of which the complaint alleges we were aware. The complaint seeks class certification, unspecified compensatory damages or rescission, as appropriate, and costs and disbursements relating to the lawsuit, including reasonable attorneys' fees. On December 1, 2006, Tri-S removed the lawsuit to the United States District Court for the Northern District of Georgia. Plaintiff moved to remand the case back to the state court, which motion was granted on September 14, 2007, and the case is now pending in the State Court of Fulton County, State of Georgia. Tri-S and the other defendants each filed answers in response to the Complaint on August 13, 2008. On that same date, they also filed a joint motion to dismiss, or in the alternative, a motion for judgment on the pleadings (the Motion to Dismiss) and a motion for a stay of discovery (the Motion for Stay) pending a decision on the Motion to Dismiss. Plaintiff opposed the Motion for Stay on October 8, 2008 and the Motion to Dismiss on October 16, 2008. The Court stayed proceedings in the action until March 9, 2009 because of the parties' on-going settlement discussions. On March 9, 2009, the parties filed a Joint Stipulation of Settlement and Release (the Settlement Agreement). The Court granted preliminary approval to the Settlement Agreement on March 10, 2009 (the Preliminary Approval Order). The Preliminary Approval Order (i) certified on a provisional basis a class of purchasers of certain Tri-S units, common stock, and warrants and (ii) scheduled a fairness hearing for June 1, 2009. Notice of the proposed settlement will be sent to potential class members and the class administrator will administer the notice and payment process. Under the terms of the Settlement Agreement and the Preliminary Approval Order, a payment of \$1,000,000 was made (on behalf of all defendants) on March 20, 2009 (the Cash Settlement Payment) in return for, among other things, a release and dismissal with prejudice of all claims against us and the other defendants. Our insurance carrier funded the Cash Settlement Payment. The final approval of the Settlement Agreement is subject to the satisfaction of certain conditions, including, without limitation, the entry by the Court of a final order approving the Settlement Agreement. If such final approval is not obtained, then the Settlement Agreement will become null and void.

On December 10, 2007, Tri-S filed an action in the Superior Court of Fulton County, State of Georgia, against Axis Reinsurance Company and Axis Insurance Company (collectively Axis) for declaratory and injunctive relief. Axis issued a Directors, Officers, and Corporate Liability Insurance Policy to Tri-S for the period from March 13, 2006 to March 13, 2007 (the Axis Policy). Tri-S provided notice of the Unschuld Litigation to Axis on November 8, 2006. On November 9, 2007, attorneys for Axis informed Tri-S that Axis disclaimed coverage for the Unschuld Litigation. Tri-S seeks (i) a declaratory judgment that coverage for the Unschuld Litigation is not barred by an exclusion in the Axis Policy related to the litigation with the Selling Shareholders of Paragon Systems and that Axis is required to advance defense costs incurred in connection with the Unschuld Litigation and (ii) an order requiring Axis to advance such defense costs. On April 11, 2008, Tri-S moved to dismiss Axis Insurance Company from the action without prejudice. The Court granted the motion on April 15, 2008. Axis Reinsurance Company removed the case to the United States District Court for the Northern District of Georgia on April 16, 2008 and filed an answer in that court on April 23, 2008. The parties stipulated to a voluntary dismissal of the action without prejudice on June 11, 2008 and the case was dismissed on June 12, 2008.

On March 13, 2008, Tri-S filed an action in the Superior Court of Fulton County, State of Georgia, against Capitol Specialty Insurance Corporation (Capitol), McGriff, Seibels & Williams of Georgia, Inc. and McGriff, Seibels & Williams, Inc. (collectively, McGriff), seeking declaratory relief and damages. McGriff acted as Tri-S's broker in obtaining the Axis Policy. Capitol issued a Directors and Officers Liability Insurance Policy to Tri-S for the period from February 9, 2005 to March 13, 2006 (the Capitol Policy). Tri-S provided notice under the Capitol Policy of the Unschuld Litigation on December 13, 2007. Coverage under that policy was denied on January 25, 2008. In the event that the Unschuld Litigation is not covered under the Axis Policy, Tri-S is seeking (i) a declaration that the Capitol Policy requires Capitol to advance defense costs in connection with the Unschuld Litigation; (ii) an order requiring Capitol to advance such defense costs; (iii) a declaration that the Capitol Policy requires Capitol to cover all loss incurred in connection with the Unschuld Litigation; and (iv) an order requiring Capitol to pay for any such loss. In the event that Tri-S is not fully covered under either the Axis Policy or the Capitol Policy in connection with the Unschuld Litigation, Tri-S is seeking (a) damages, in an amount to be determined at trial, against McGriff for negligence, breach of contract, negligence per se, negligent procurement, negligent misrepresentation, professional negligence, and breach of fiduciary duty; (b) a declaration that McGriff is required to cover any loss as defined in the Axis Policy that Tri-S incurs in connection with the Unschuld Litigation up to the limit of liability of the Axis Policy; and (c) an order requiring McGriff to advance defense costs incurred in connection with the Unschuld Litigation. On April 11, 2008, Tri-S voluntarily dismissed the action without prejudice.

On May 13, 2008, Tri-S filed a complaint in the Superior Court of Fulton County, State of Georgia against Axis Reinsurance Company, Capitol, and McGriff combining Tri-S's claims related to coverage for the Unschuld Litigation. Tri-S seeks (i) a declaratory judgment that the Axis Policy provides coverage for loss incurred in connection with the Unschuld Litigation and that coverage is not barred by an exclusion in the Axis Policy related to the litigation with the Selling Shareholders of Paragon Systems or by any other provision of the policy; (ii) an order requiring Axis to advance defense costs incurred in connection with the Unschuld Litigation; and (iii) an order requiring Axis to cover loss for claims related to

the Unschuld Litigation. In the alternative, and to the extent the Unschuld Litigation is not covered by the Axis Policy, Tri-S seeks (i) a declaration that the Capitol Policy requires Capitol to pay defense expenses in connection with the Unschuld Litigation; (ii) an order requiring Capitol to pay such defense expenses; (iii) a declaration that the Capitol Policy requires Capitol to cover all loss incurred in connection with the Unschuld Litigation; and (iv) an order requiring Capitol to pay for such loss. Tri-S also seeks damages against McGriff for negligence, breach of contract, and breach of fiduciary duty in an amount to be determined. In the event that Tri-S is not fully covered under either the Axis Policy or the Capitol Policy, Tri-S further seeks a declaration that McGriff is required to cover loss incurred in connection with the Unschuld Litigation and an order requiring McGriff to advance defense costs incurred in connection with the Unschuld Litigation. Axis answered the complaint and asserted affirmative defenses on June 11, 2008. Capitol answered the complaint and asserted affirmative defenses on July 17, 2008. The parties agreed to extend McGriff's time to answer through and including June 8, 2009. The case is currently scheduled to go to trial on June 9, 2009.

#### **Litigation Concerning 10% Notes**

On April 28, 2009, an action was filed against the Company by Mark Machi in the Superior Court of Fulton County, State of Georgia, for damages and attorneys' fees. The complaint alleges that the Company issued a 10% Note to the plaintiff in the principal amount of \$50,000 and that such note has matured. The complaint further alleges that the Company is indebted to the defendant for the principal amount of the 10% Note, plus interest. The plaintiff seeks as damages \$50,000, plus interest, as well as attorneys' fees and the expenses of litigation.

On May 1, 2009, an action was filed against the Company by Vincent Carbone, Clara Sola, Luis Baumeiser, Mercedes Cubillan, and Denton Business, Inc. in the Superior Court of Fulton County, State of Georgia. The complaint alleges that the Company issued a 10% Note in favor of each of the plaintiffs and that each of such notes has matured. The complaint further alleges that the Company has failed to pay the principal amount due under each of the 10% Notes, plus accrued interest. The plaintiffs seek a total of \$500,000, the alleged aggregate principal value of all of the 10% Notes, plus interest, as well as attorneys' fees and the costs of court.



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**Item 5. Other Information.**

On May 13, 2009, Cornwall and certain of its subsidiaries (collectively, Sellers ), and the Company entered into that certain Asset Purchase Agreement (the Purchase Agreement ) with U.S. Security Associates, Inc. ( Buyer ), pursuant to which Sellers sold to Buyer (the Cornwall Sale ) substantially all of the assets (except for accounts receivable) used by Sellers in connection with their business of providing guard, patrol and security services (the Business ), for a purchase price of approximately \$3.6 million (the Purchase Price ). In connection with the Cornwall Sale, on May 13, 2009: (i) the Company, Paragon Systems, Sellers and certain affiliates of the Company (collectively, the Parties ) entered into a Non-Compete Agreement with Buyer, pursuant to which the Parties agreed, for a period of five years after closing of the Cornwall Sale, not to engage, directly or indirectly, in the Business within a 200 mile radius of Miami, Florida (the Territory ), not to solicit employees or actual or prospective customers of Sellers, and not to disclose confidential information about the Business, subject to certain exceptions, including, without limitation, that Paragon Systems may pursue the Business with respect to federal government contracts in the Territory; and (ii) Sellers, Buyer and SunTrust Bank entered into an Escrow Agreement, pursuant to which \$750,000 of the Purchase Price is being held in escrow to secure the continuation of certain contracts transferred as part of the Cornwall Sale until 90 days thereafter. In order to effect the transactions contemplated by the Purchase Agreement, Sellers and Buyer also entered into certain conveyance documents which are filed as exhibits to this Quarterly Report.

**Item 6. Exhibits.**

The exhibits required to be filed with this Quarterly Report are set forth on the Exhibit Index included herein.

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**SIGNATURE**

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.

**TRI-S SECURITY CORPORATION**

Date: May 15, 2009

/s/ Ronald G. Farrell  
Ronald G. Farrell  
Chairman of the Board and Chief Executive Officer

(duly authorized signatory and Principal Executive Officer)

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<b>Exhibit No.</b>	<b>Description</b>	<b>Method of Filing</b>
2.1	Asset Purchase Agreement, dated May 13, 2009, among the Company, The Cornwall Group, Inc. and certain of its affiliates, and U.S. Security Associates, Inc. (The Schedules to the Asset Purchase Agreement have been omitted from this Quarterly Report pursuant to Item 601(b)(2) of Regulation S-K, and the Company agrees to furnish copies of such omitted Schedules supplementally to the SEC upon request.)	Filed herewith.
3.1	Amended and Restated Articles of Incorporation.	Incorporated by reference to Exhibit 3.1 to the Company's Registration Statement on Form S-1 (No. 333-119737).
3.2	Amended and Restated Bylaws.	Incorporated by reference to Exhibit 3.2 to the Company's Registration Statement on Form S-1 (No. 333-119737).
3.3	Articles of Amendment to Amended and Restated Articles of Incorporation of the Company, dated September 14, 2007.	Incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed on September 19, 2007.
3.4	Amendment to the Amended and Restated Bylaws of the Company, adopted September 13, 2007.	Incorporated by reference to Exhibit 3.2 to the Company's Current Report on Form 8-K filed on September 19, 2007.
3.5	Amendment to the Amended and Restated Bylaws of the Company, adopted December 13, 2007.	Incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed on December 19, 2007.
4.1	Warrant to purchase 90,000 shares of the Company's common stock issued to BRE LLC on January 7, 2009.	Incorporated by reference to Exhibit 4.23 on the Company's Yearly Report on Form 10-K for the year ending December 31, 2008.
4.2	Form of 14% Convertible Promissory Note issued to accredited investors on January 8, 2009.	Incorporated by reference to Exhibit 4.24 on the Company's Yearly Report on Form 10-K for the year ending December 31, 2008.
4.3	Form of warrant to purchase 3,906 shares of the Company's common stock issued to accredited investors on January 8, 2009.	Incorporated by reference to Exhibit 4.25 on the Company's Yearly Report on Form 10-K for the year ending December 31, 2008.
4.4	Form of warrant to purchase 65,000 shares of the Company's common stock issued as compensation to a registered representative on January 9, 2009, in connection with the Company's exchange offer conducted on November 13, 2008.	Incorporated by reference to Exhibit 4.26 on the Company's Yearly Report on Form 10-K for the year ending December 31, 2008.
4.5	Form of 14% Convertible Promissory Note issued to an accredited investor on February 3, 2009.	Incorporated by reference to Exhibit 4.27 on the Company's Yearly Report on Form 10-K for the year ending December 31, 2008.
4.6		

## Edgar Filing: TRI-S SECURITY CORP - Form 10-Q

	Form of warrant to purchase 5,208 shares of the Company's common stock issued to an accredited investor on February 3, 2009.	Incorporated by reference to Exhibit 4.28 on the Company's Yearly Report on Form 10-K for the year ending December 31, 2008.
4.7	Form of 14% Convertible Promissory Note issued to an accredited investor on February 25, 2009.	Incorporated by reference to Exhibit 4.29 on the Company's Yearly Report on Form 10-K for the year ending December 31, 2008.
4.8	Form of warrant to purchase 10,417 shares of the Company's common stock issued to an accredited investor on February 25, 2009.	Incorporated by reference to Exhibit 4.30 on the Company's Yearly Report on Form 10-K for the year ending December 31, 2008.
10.1	Joint Stipulation of Settlement and Release between Hal Unschuld, individually and on behalf of the class he seeks to represent, the Company, Ronald Farrell, E. Wayne Stallings, Capital Growth Financial, LLC and Bathgate Capital Partners, LLC, filed March 9, 2009 (approved March 10, 2009 by the State Court of Fulton County, State of Georgia. A fairness hearing is scheduled for June 1, 2009).	Incorporated by reference to Exhibit 10.65 on the Company's Yearly Report on Form 10-K for the year ending December 31, 2008.
10.2	Escrow Agreement, dated May 13, 2009, among The Cornwall Group, Inc. and certain of its affiliates, U.S. Security Associates, Inc. and SunTrust Bank.	Filed herewith.
10.3	Non-Compete Agreement, dated May 13, 2009, among the Company, The Cornwall Group, Inc. and certain of its affiliates, and U.S. Security Associates, Inc.	Filed herewith.
10.4	Assignment and Assumption Agreement, dated May 13, 2009, among The Cornwall Group, Inc. and certain of its affiliates, and U.S. Security Associates, Inc.	Filed herewith.
10.5	Bill of Sale, dated May 13, 2009, among The Cornwall Group, Inc. and certain of its affiliates, and U.S. Security Associates, Inc.	Filed herewith.
31.1	Rule 13a-14(a)/15d-14(a) Certification of the Company's Chief Executive Officer.	Filed herewith.
31.2	Rule 13a-14(a)/15d-14(a) Certification of the Company's Chief Financial Officer.	Filed herewith.
32.1	Section 1350 Certification of the Company's Chief Executive Officer.	Filed herewith.
32.2	Section 1350 Certification of the Company's Chief Financial Officer.	Filed herewith.