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REGENCY AFFILIATES INC
Form 10QSB
August 23, 2004

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

FORM 10-QSB

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

For the quarterly period ended June 30, 2004

OR

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

COMMISSION FILE NUMBER 1-7949

REGENCY AFFILIATES, INC.

(Exact name of registrant as specified in its charter)

Delaware

72-0888772

(State or other jurisdiction of
Incorporation or organization)

(IRS Employer Identification Number)

610 N.E. Jensen Beach Blvd., Jensen Beach, Florida

34957

(Address of principal executive offices)

(Zip Code)

Registrant's Telephone Number, including Area Code (772) 334-8181

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

As of August 9, 2004 there were 3,019,412 shares of the \$.01 Par Value Common Stock outstanding.

Transitional Small Business Disclosure Form (check one): Yes No

Regency Affiliates, Inc. and Subsidiaries
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Item 1. Financial Statements

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Regency Affiliates, Inc. and Subsidiaries
Condensed Consolidated Balance Sheet
June 30, 2004

Assets

| | |
|-----------------------------|--------------|
| Current Assets | |
| Cash and cash equivalents | \$ 1,594,584 |
| Marketable securities | 8,997,870 |
| Accrued receivables | 289,659 |
| Other current assets | 96 |
| | ----- |
| Total Current Assets | 10,882,209 |
| Property and equipment, net | 4,228 |
| Investment in partnerships | 8,124,553 |
| Other Assets | |
| Aggregate inventory | 832,413 |
| Deferred costs | 250,000 |
| Other | 1,300 |
| | ----- |
| Total Other Assets | 1,083,713 |
| | ----- |

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| | |
|--|------------------------|
| Total Assets | \$ 20,094,703 ===== |
| Liabilities and Shareholders' Equity | |
| Current Liabilities | |
| Accounts payable | \$ 156,666 |
| Accrued expenses | 318,858 |
| | ----- |
| Total Current Liabilities | 475,524 |
| Deferred credit | 1,164,530 |
| | ----- |
| Total Liabilities | 1,640,054 ----- |
| Commitments and contingencies | |
| Shareholders' Equity | |
| Serial preferred stock not subject to mandatory redemption (Maximum liquidation preference \$24,975,312) | 1,052,988 |
| Common stock, par value \$.01; authorized 8,000,000 shares; issued 4,179,145 shares; outstanding 3,018,912 shares | 37,739 |
| Additional paid-in capital | 8,183,664 |
| Readjustment resulting from quasi-reorganization at December 31, 1987 | (1,670,596) |
| Retained earnings | 13,309,097 |
| Note receivable - sale of stock | (2,440,000) |
| Treasury stock, 1,160,233 shares | (18,243) |
| | ----- |
| Total Shareholders' Equity | 18,454,649 ----- |
| Total Liabilities and Shareholders' Equity | \$ 20,094,703 ===== |

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Regency Affiliates, Inc. and Subsidiaries
Condensed Consolidated Statements of Operations

| | Three Months Ended June 30, | | S |
|--|-----------------------------|-----------|-------|
| | 2004 | 2003 | |
| | ----- | ----- | ----- |
| Net Sales | \$ -- | \$ -- | \$ |
| Costs and expenses | | | |
| Costs of goods sold | -- | -- | |
| Selling, general and administrative expenses | 790,377 | 1,189,235 | 2 |
| | ----- | ----- | ----- |
| | 790,377 | 1,189,235 | 2 |
| | ----- | ----- | ----- |

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| | | | |
|--|-----------|-------------|-----|
| Loss from operations | (790,377) | (1,189,235) | (2) |
| Income from equity investment in partnerships | 463,191 | 1,439,961 | |
| Rental income | -- | 24,096 | |
| Interest and dividend income | 29,861 | 43,879 | |
| Other income, net | 21,836 | -- | |
| Interest expense | -- | (326,971) | |
| | ----- | ----- | |
| Income from operations before income tax provision | (275,489) | (8,270) | (1) |
| Provision for income taxes | -- | 68,824 | |
| | ----- | ----- | |
| Net Income (Loss) | (275,489) | (77,094) | (1) |
| | ===== | ===== | |
| Net income (loss) per common share: | | | |
| Basic | \$ (0.09) | \$ (0.04) | \$ |
| | ===== | ===== | |
| Diluted | \$ (0.09) | \$ (0.02) | \$ |
| | ===== | ===== | |
| Weighted average number of common shares outstanding | | | |
| Basic | 3,018,912 | 1,995,771 | 3 |
| | ===== | ===== | |
| Diluted | 3,018,912 | 3,144,520 | 3 |
| | ===== | ===== | |

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Regency Affiliates, Inc. and Subsidiaries
Condensed Consolidated Statements of Cash Flows

| | Six Months Ended June 30, | |
|---|---------------------------|---------|
| | 2004 | 2003 |
| | ----- | ----- |
| Cash Flows from operating activities | | |
| Net income (loss) | \$ (1,654,763) | \$ 827, |
| Adjustments to reconcile net income (loss) to net cash used in operating activities | | |
| Depreciation and amortization | 2,329 | 238, |
| Stock-based compensation | 3,125 | |
| Income from equity investment in LLC/partnerships | (862,657) | (3,010, |
| Impairment of notes, accrued interest receivable | 1,182,626 | |
| Distribution of earnings from partnership | -- | 41,119, |
| Interest accretion on long-term debt | -- | 474, |
| Unrealized gain on marketable securities | (57,084) | |
| Changes in operating assets and liabilities | | |
| Restricted cash | 80,783 | |
| Accounts receivable | 3,077 | |
| Loan receivable | -- | 250, |
| Accrued receivables | -- | (12, |
| Income taxes receivable | -- | 11, |
| Accrued interest receivable - related party | (45,253) | (81, |

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| | | |
|---|---------------------------|------------|
| Other current assets | 64,212 | 6, |
| Accounts payable | (444,284) | 11, |
| Accrued expenses | 212,935 | (150, |
| | ----- | ----- |
| Net cash provided by (used in) operating activities | (1,514,954) | 39,684, |
| | ----- | ----- |
| Cash flows from investing activities | | |
| Cash investments in MESC Capital, LLC | (7,300,145) | |
| Payments received on notes receivable | 1,563 | |
| Proceeds from sales of marketable securities | 94,500,000 | |
| Purchases of marketable securities | (84,945,761) | |
| Net proceeds from sale of property and equipment | 402,632 | |
| | ----- | ----- |
| Net cash provided by investing activities | 2,658,289 | |
| | ----- | ----- |
| Cash flows from financing activities | | |
| Net long-term payments | -- | (14,564, |
| Net short-term payments | -- | (1,174, |
| | ----- | ----- |
| Net cash used in financing activities | \$ -- | \$(15,738, |
| | ===== | ===== |
| Increase in cash and cash equivalents | \$ 1,143,335 | \$ 23,945, |
| Cash and cash equivalents - beginning | 451,249 | 101, |
| | ----- | ----- |
| Cash and cash equivalents - ending | \$ 1,594,584 | \$ 24,046, |
| | ===== | ===== |
| | | |
| | Six Months Ended June 30, | |
| | ----- | ----- |
| | 2004 | 2003 |
| | ----- | ----- |
| Supplemental disclosures of cash flow information: | | |
| Cash paid during the year for | | |
| Interest | \$ -- | \$ 4,300, |
| Income taxes | -- | 251, |

Regency Affiliates, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements

Note 1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Item 310 of Regulation S-B. 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 (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and six month periods ended June 30, 2004 are not necessarily indicative of the results that may be expected for the year ended December 31, 2004. For further information, refer to the

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consolidated financial statements and footnotes thereto included in the Company's annual report on Form 10-KSB for the year ended December 31, 2003.

Principles of Consolidation - The consolidated financial statements include the accounts of Regency Affiliates, Inc. (the "Company"), its wholly owned subsidiaries, Regency Power Corporation ("Regency Power") and Rustic Crafts International, Inc. ("Rustic Crafts") (through September 20, 2002 the date that Rustic Crafts' operating assets were disposed of), its 75% owned subsidiary, Iron Mountain Resources, Inc. ("IMR"), and its 80% owned subsidiary, National Resource Development Corporation ("NRDC"). All significant intercompany balances and transactions have been eliminated in consolidation.

Note 2. Earnings Per Share

Basic earnings per share are computed by dividing net income attributable to common shareholders (net income less preferred stock dividend requirements and periodic accretion if applicable) by the weighted average number of common shares outstanding during the year. Diluted per share computations assume conversion of convertible debt and stock options outstanding that are "in the money".

Note 3. Property and Equipment

On January 12, 2004, the Company sold its rental property located in Scranton, PA for \$531,500, less costs to sell of approximately \$48,000. No gain or loss was recognized on the transaction as the property was written down to fair value at December 31, 2003. Property and equipment at June 30, 2004 was as follows:

| | |
|--------------------------------|-----------|
| Machinery and equipment | \$ 43,708 |
| Less: Accumulated depreciation | (39,480) |
| | ----- |
| | \$ 4,228 |
| | ===== |

Depreciation expense for the three months ended June 30, 2004 and 2003 was \$1,164 and \$158,820, respectively. Depreciation expense for the six months ended June 30, 2004 and 2003 was \$2,329 and \$238,877, respectively.

Note 4. Notes Receivable

At March 31, 2004, the Company held notes receivable totaling \$1,127,708, which were deemed uncollectible due to lack of cash flows generated and continual default on payment terms by the issuer. Management determined to record full impairment of the notes and any accrued interest thereon, resulting in an impairment charge of \$1,182,626, which is included in the Selling, General & Administrative caption of the accompanying Condensed Consolidated Statements of Operations for the six months ended June 30, 2004.

Note 5. Litigation

On January 20, 2004, a purported derivative and class action lawsuit was filed

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by two individual shareholders of the Company in the New Castle County Court of Chancery, Delaware, naming as defendants certain current and former directors of the Company, Royalty Holdings LLC and certain of its affiliates, Statesman Group, Inc. and, nominally, the Company. The complaint alleges, among other things, breaches of fiduciary duties by the former director defendants and Statesman Group, Inc. in connection with (i) the exercise by Statesman Group, Inc. in 2001 of an option to acquire shares of common stock of the Company, (ii) the 2001 sale of rock aggregate by the Company to Iron Mountain Resources, Inc. and (iii) the October 2002 recapitalization of the Company. The complaint also alleges breaches of fiduciary duties by the current director defendants in connection with the payment by the Company in 2003 of accrued compensation owed to William R. Ponsoldt, Sr. for periods prior to the October 2002 recapitalization of the Company. The complaint also alleges that Royalty Holdings LLC and its affiliates knowingly participated in the breaches of fiduciary duties by the former director defendants relating to the October 2002 recapitalization of the Company.

In addition to other damages, plaintiffs seek unspecified compensatory and/or rescissory damages against all defendants, a declaration that all Company stock issued to Statesman Group, Inc., William R. Ponsoldt, Sr., Royalty Holdings LLC and any person affiliated with the foregoing is void, an order rescinding any payments in any form made by the Company to William R. Ponsoldt, Sr. or any of his affiliates or family members, an order rescinding the October 2002 recapitalization of the Company, and an order rescinding Statesman Group, Inc.'s 2001 option exercise and rescinding the option itself. The Company, as a nominal defendant, has not taken any position with respect to the merits of the lawsuit. However, the Company understands that the other defendants in the lawsuit believe that the claims raised by the plaintiffs are without merit, and that such defendants intend to defend the claims vigorously.

The defendants in the lawsuit other than Statesman Group, Inc. are entitled to be indemnified by the Company for damages, if any, and expenses, including legal fees, they may incur as a result of the lawsuit, subject to certain circumstances under which such indemnification is not available. In addition, other than with respect to the claims against the current director defendants in their capacities as such, the claims contained in the lawsuit are not covered by insurance, as the Company's carrier has declined coverage on the basis of the "insured vs. insured" exclusion since one of the named plaintiffs, Donald D. Graham, was previously a director of the Company. The Company had submitted a claim to its carrier with respect to the claims in the lawsuit against the current director defendants and the insurance carrier has denied the Company's claim.

On May 10, 2004, Gary Nuttall, a former President of the Company, commenced an arbitration against the Company with respect to certain claims allegedly arising under his 1995 Employment Agreement with the Company. He is seeking severance and all other compensation and benefits due him under the 1995 Employment Agreement in an amount in excess of approximately \$1,650,000 (\$1,400,000 of which is a financing bonus), 466,667 unrestricted shares of the Company (pre-split), options to purchase additional stock of the Company, punitive damages, interest, fees and costs associated with the arbitration. The Company believes the claims are without merit and intends to defend them vigorously.

Note 6. Commitments and Contingencies

Pursuant to the Regency Power's acquisition of a 50% membership interest in MESC Capital, LLC (see Note 7), the Company contracted with an unaffiliated investment consulting firm to provide advisory services in connection with negotiation of the acquisition. Under the contract, the Company incurred success fees of \$350,000, of which \$150,000 was paid during the three months ended June 30, 2004. The balance of these fees of \$200,000 are due and payable on March 31, 2005, provided, however, that such \$200,000 installment shall no longer be due

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and payable if, on or prior to March 31, 2005, the Energy Services Agreement between Mobile Energy Services Company, LLC and Kimberly-Clark shall have been terminated for any reason. In accordance with Statement of Financial Accounting Standards No. 5, the amount of the gain, if any, that may be ultimately realized from reversal of this provision has not been reflected in the accompanying financial statements.

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Regency Affiliates, Inc. and Subsidiaries Notes to Condensed Consolidated Financial Statements

Note 7. Investment in LLC

On April 30, 2004, the Company, through a newly-formed, wholly-owned subsidiary called Regency Power Corporation, a Delaware corporation, acquired a 50% membership interest in MESC Capital, LLC, a Delaware limited liability company ("MESC Capital"), from DTE Mobile, LLC ("DTE Mobile"), pursuant to an Assignment and Assumption Agreement dated as of April 30, 2004. The purchase price for the 50% membership interest was \$3,000,000 and was funded from Regency's working capital. The terms of the Assignment and Assumption Agreement were negotiated on an arms'-length basis between Regency and DTE Mobile. DTE Mobile, which is owned by an unregulated subsidiary of a large energy company that has significant experience in owning, managing and operating electric generation and on-site energy facilities, owns the other 50% membership interest in MESC Capital.

MESC Capital was formed to acquire all of the membership interests in Mobile Energy Services Company, LLC ("Mobile Energy"), an Alabama limited liability company. Mobile Energy owns an on-site energy facility that supplies steam and electricity to a Kimberly-Clark tissue mill in Mobile, Alabama. The acquisition of Mobile Energy was also consummated on April 30, 2004 pursuant to a Membership Interest Purchase Agreement, dated as of January 30, 2004, between MESC Capital and Mobile Energy Services Holdings, Inc. The purchase price under the Membership Interest Purchase Agreement, after certain pre-closing adjustments, was \$33,600,000, and is subject to certain post-closing adjustments. The purchase price and working capital reserves were funded by the issuance of \$28,500,000 of non-recourse debt, a total equity contribution by MESC Capital of \$8,600,290, \$4,300,145 of which was funded by Regency Power and \$4,300,145 of which was funded by DTE Mobile, and a credit of \$1,000,000 on account of existing and continuing tax-exempt indebtedness of Mobile Energy. The terms of the Membership Interest Purchase Agreement were negotiated on an arms'-length basis between MESC Capital and Mobile Energy Services Holdings, Inc. The Company did not participate in negotiations with respect to the Membership Interest Purchase Agreement.

The \$28,500,000 acquisition indebtedness was obtained from Allied Irish Banks, P.L.C., which may assign or participate the loan in accordance with the terms of the loan agreement. The loan will be amortized over the fifteen year term. In connection with the acquisition of the 50% membership interest in MESC Capital, Regency Power and DTE Mobile entered into an Operating Agreement, dated April 30, 2004, which sets forth their respective rights and obligations as members of MESC Capital as well as the duties and authority of DTE Mobile as the managing member of MESC Capital. Under the Operating Agreement, Regency Power will receive 50% of all distributions. Neither Regency Power nor DTE Mobile is obligated to contribute additional capital, or loan or otherwise advance funds, to MESC Capital, and neither member can sell or transfer its interest in MESC Capital without the consent of the other and without first complying with a right of first offer in favor of the non-selling member.

Pursuant to APB No. 18, the Company is accounting for this investment under the

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equity method of accounting. The accompanying statements of operations include the equity income from operations of MESC Capital for the period from April 30, 2004 (date of acquisition) through June 30, 2004.

The following summarized income statement information is presented for MESC Capital for the period from April 30, 2004 (date of acquisition) and its predecessor, Mobile Energy Services Holdings, Inc. ("MESH"), for the period from January 1, 2004 to April 29, 2004:

| | Three Months Ended June 30, 2004 | Six Months Ended June 30, 2004 |
|-----------------------------------|-------------------------------------|-----------------------------------|
| | ----- | ----- |
| Sales | \$2,806,547 | \$9,672,994 |
| Gross profit | \$2,179,262 | \$4,258,726 |
| Income from continuing operations | \$ 375,420 | \$ 63,814 |
| Net Income | \$ 375,420 | \$ 63,814 |

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Regency Affiliates, Inc. and Subsidiaries

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION.

Forward-Looking Statements and Associated Risk

Certain statements contained in this Quarterly Report on Form 10-QSB, including, but not limited to those regarding the Company's financial position, business strategy, acquisition strategy and other plans and objectives for future operations and any other statements that are not historical facts constitute "forward-looking statements" within the meaning of federal securities laws and the Private Securities Litigation Reform Act of 1995. Such forward-looking statements involve known and unknown risks, uncertainties and other important factors that could cause the actual results, performance or achievements expressed or implied by such forward-looking statements to differ materially from any future results, performance or achievements expressed or implied by such forward-looking statements. Although the Company believes that the expectations reflected in these forward-looking statements are reasonable, there can be no assurance that the actual results or developments anticipated by the Company will be realized or, even if substantially realized, that they will have the expected effect on its business or operations. These forward-looking statements are made based on management's expectations and beliefs concerning future events impacting the Company and are subject to uncertainties and factors (including, but not limited to, those specified below) which are difficult to predict and, in many instances, are beyond the control of the Company. Such factors include:

- A default in the lease or sudden catastrophe to the property owned by Security Land and Development Company Limited Partnership ("Security") or the operating facilities owned by Mobile Energy Services Company, LLC ("Mobile Energy") from uninsured acts of God or war could have a materially adverse impact upon our investment in Security or Mobile Energy, respectively, and therefore our financial position and results of operations;

- Our subsidiaries currently lack the necessary infrastructure at the site of the Groveland mine in order to permit them to make more than casual sales of the Aggregate;

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- We have had significant tax loss and credit carryforwards and no assurance can be provided that the Internal Revenue Service would not attempt to limit or disallow altogether our use, retroactively and/or prospectively, of such carryforwards, due to ownership changes or any other reason. The disallowance of the utilization of our net operating loss would severely impact or financial position and results of operations due to the significant amounts of taxable income that has been, and may in the future be, offset by our net operating loss carryforwards;

- Royalty, an affiliate of the Company's management, beneficially owns approximately 60% of our common stock. As a result, Royalty has the ability to control the outcome of all matters requiring shareholder approval, including the election and removal of directors and any merger, consolidation or sale of all or substantially all of our assets; and

- Regency does not expect to pay dividends in the foreseeable future.

The following discussion and analysis of the financial condition and results of operations of Regency should be read in conjunction with the accompanying financial statements and related notes included in Item 1 of this report.

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Regency Affiliates, Inc. and Subsidiaries

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION. (continued)

General.

The Company is committed to enhancing the value of the Company's Common Stock by seeking opportunities to monetize certain existing assets and by seeking new business opportunities on an opportunistic basis.

Liquidity and Capital Resources.

On June 30, 2004, Regency had current assets of \$10,882,209 and Shareholders' Equity of \$18,454,649. On June 30, 2004, Regency had \$10,592,454 in cash and marketable securities, total assets of \$20,094,703 and total current liabilities of \$475,524.

On April 30, 2004, the Company through a newly-formed, wholly-owned subsidiary called Regency Power Corporation, a Delaware corporation, acquired a 50% membership interest in MESC Capital, LLC, a Delaware limited liability company ("MESC Capital"), from DTE Mobile, LLC ("DTE Mobile"), pursuant to an Assignment and Assumption Agreement dated as of April 30, 2004. The purchase price for the 50% membership interest was \$3,000,000 and was funded from Regency's working capital. DTE Mobile, which is owned by an unregulated subsidiary of a large energy company that has significant experience in owning, managing and operating electric generation and on-site energy facilities, owns the other 50% membership interest in MESC Capital.

MESC Capital was formed to acquire all of the membership interests

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in Mobile Energy Services Company, LLC, an Alabama limited liability company. Mobile Energy owns an on-site energy facility that supplies steam and electricity to a Kimberly-Clark tissue mill in Mobile, Alabama. The acquisition of Mobile Energy was also consummated on April 30, 2004 pursuant to a Membership Interest Purchase Agreement, dated as of January 30, 2004, between MESC Capital and Mobile Energy Services Holdings, Inc. The purchase price under the Membership Interest Purchase Agreement, after certain pre-closing adjustments, was \$33,600,000, and is subject to certain post-closing adjustments. The purchase price and working capital reserves were funded by the issuance of \$28,500,000 of non-recourse debt, a total equity contribution by MESC Capital of \$8,600,290, \$4,300,145 of which was funded by Regency Power and \$4,300,145 of which was funded by DTE Mobile, and a credit of \$1,000,000 on account of existing and continuing tax-exempt indebtedness of Mobile Energy. The \$28,500,000 acquisition indebtedness will be fully amortized over the fifteen year term. Neither Regency Power nor DTE Mobile is obligated to contribute additional capital, or loan or otherwise advance funds, to MESC Capital.

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Regency Affiliates, Inc. and Subsidiaries

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION. (continued)

At March 31, 2004, the Company held notes receivable totaling \$1,127,708, which were deemed uncollectible due to lack of cash flows generated and continual default on payment terms by the issuer. Management determined to record full impairment of the notes and any accrued interest thereon, resulting in an impairment charge of \$1,182,626, which is included in the Selling, General & Administrative caption of the accompanying Statements of Operations. Management intends however, to continue to pursue options available to receive payment on the obligations from debtor.

On June 24, 2003, US SSA LLC, a single purpose entity owned by Security, borrowed \$98,500,000 through a public debt issue underwritten by CTL Capital, LLC. Proceeds of the refinancing were used to repay the outstanding balance of Security's 1994 indebtedness, to establish reserves to make capital improvements to the property, to provide reserves required by the new debt, to pay costs and expenses related to issuing the debt, to pay fees related to the lease extension with the GSA and the financing, and to make a distribution to the partners of Security. The debt is for a term of 15.3 years maturing October 31, 2018 at which time the loan will have been paid down to a balance of \$10,000,000.

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Regency Affiliates, Inc. and Subsidiaries

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION. (continued)

Security also successfully obtained residual value insurance for approximately \$10,000,000. The interest cost of the financing is 4.63%. The financing is non-recourse to the Company. The Company received approximately \$41,000,000 from the Security distribution.

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In addition, under the terms of the Security partnership agreement, the Company is entitled to (i) 95% of Security's distributions of cash flow until it has received \$2,000,000 of such distributions, and thereafter 50% of such distributions and (ii) once it has received \$2,000,000 of cash flow distributions, a \$180,000 annual management fee from Security. The foregoing percentages are inclusive of the Company's interest as a limited partner in 1500 Woodlawn, the general partner of Security. In connection with the Security refinancing and distribution, the Company was required to repay its KBC Bank loan. The payoff amount was approximately \$14,125,000, which included a release fee and make-whole premium.

In order to satisfy the Company's working capital needs, in April 2003 the Company obtained a loan facility from Royalty Holdings LLC ("Royalty"), an affiliate of Messrs. Levy and Hasson, pursuant to which the Company could have borrowed up to an aggregate of \$300,000 from Royalty. Amounts borrowed were evidenced by a demand note bearing interest of 8% per annum. On July 3, 2003, the Company repaid all amounts outstanding under the \$300,000 working capital loan facility from Royalty, and terminated the facility. The payment amount consisted of \$180,000 of principal and \$2,910 of accrued and unpaid interest.

On October 16, 2002, the Company redeemed all the shares of Common Stock owned by Statesman Group, Inc. ("Statesman"), a former shareholder of the Company. The Company funded the redemption from the proceeds of an aggregate of \$4,750,000 borrowed from Royalty, an affiliate of current management, in exchange for two notes - a \$3,500,000 5% Convertible Promissory Note due October 16, 2012 and a \$1,250,000 9% Promissory Note due October 16, 2007. Both notes allowed interest to accrue without current payment. The principal and interest under the Convertible Promissory Note could be converted into Common Stock at a conversion rate of \$2.00 per shares.

On November 7, 2002, Royalty converted \$1,495,902 of the principal amount of the Convertible Note plus accrued interest into 750,000 shares of Common Stock and on July 3, 2003, Royalty converted the remaining \$2,004,098 outstanding principal amount of the Convertible Note and the \$71,378 of accrued and unpaid interest thereon into 1,037,738 shares of the Company's Common Stock. The 9% Promissory Note was required to be prepaid upon our receipt of sufficient proceeds from the Company's investment in Security after discharging certain other indebtedness. Accordingly, on July 3, 2003, the Company repaid the full \$1,250,000 principal amount of, and all accrued and unpaid interest under, the 9% Promissory Note.

On September 30, 2002, our subsidiary, Rustic Crafts International, Inc. ("Rustic Crafts") sold all of its operating assets subject to the assumption of certain of its liabilities. Prior to the sale, Rustic Crafts had established a \$1,000,000 line of credit with PNC Bank which was guaranteed by the Company and expired on May 18, 2002. In conjunction with the Rustic Crafts asset sale, Rustic Crafts' indebtedness under the line of credit together with its \$960,000 mortgage loan from PNC Bank and certain other indebtedness to PNC Bank was restructured to replace such indebtedness with five notes totaling \$2,432,782 and have a ten year amortization schedule. The notes bear interest at the blended rate of 10.8% per annum. As part of the PNC Bank debt restructuring, Rustic Crafts was

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Regency Affiliates, Inc. and Subsidiaries

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION. (continued)

required to pay down the outstanding loan balance with \$200,000 of the purchase price in the Rustic Crafts asset sale, and was required to make a \$540,000 payment in December 2002. A \$40,000 payment was made to PNC Bank in December 2002, but Rustic Crafts and Regency failed to make the balance of the December 2002 payment. Accordingly, the PNC Bank debt was subsequently modified to provide for the payment of the remaining \$500,000 payment on or before June 30, 2003. On June 30, 2003, the Company paid all outstanding principal and interest due to PNC Bank, in satisfaction of the above described obligations.

Management believes that the Company's cash balance and anticipated cash flows from operations will be adequate to fund our cash requirements for at least the next twelve months.

Results of Operations.

2004 Compared to 2003

For the three months ended June 30, 2004:

No revenue was generated by the Company in this period.

Selling and administrative expenses decreased by \$398,858 or 33.5% in 2004 compared to 2003 primarily due to cost of settlement of the KBC debt incurred in the second quarter of 2003.

Income from equity investment in Security decreased by \$976,770, 67.8% less than 2003 due to an increase in interest expense relating to increased debt financing of Security, partially offset by equity income from MESC Capital.

Interest expense decreased by \$326,971 or 100% in 2004 over 2003 as a result of elimination of long term loan balances.

Net Loss increased by \$198,395 in 2004 over 2003 or 257.3%. The increase was primarily due to the income from equity investment offset by decreased interest expense and selling and administrative expenses.

The Company's Shareholders' Equity at June 30, 2004 was \$18,454,649 as compared to \$21,216,695 on June 30, 2003, a decrease of \$2,762,046.

For the six months ended June 30, 2004:

No revenue was generated by the Company in this period.

Regency Affiliates, Inc. and Subsidiaries

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION. (continued)

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Selling and administrative expenses increased by \$1,114,373 or 72.5% in 2004 compared to 2003 due primarily to the full impairment of the Rustic Craft notes and any accrued interest thereon, resulting in an impairment charge of \$1,182,626 as well as increased professional fees relating to continuing litigation defense, offset by the cost of settlement of the KBC debt incurred in the second quarter of 2003.

Income from equity investment in Security decreased by \$2,147,859 or 71.3% less than 2003 due to an increase in interest expense relating to increased debt financing of Security, partially offset by equity income from MESC Capital.

Interest expense decreased by \$712,715 or 100% in 2004 over 2003 as a result of elimination of long term loan balances.

Net income decreased by \$2,482,167 in 2004 over 2003 or 300.0%. The decrease was primarily due to the increased selling and administrative expenses and the impairment of the Rustic Craft notes (described above) as well as decreased income from equity investment, offset by decreased interest expense.

The Company's Shareholders' Equity at June 30, 2004 was \$18,454,649 as compared to \$21,216,695 on June 30, 2003, a decrease of \$2,762,046.

Impact of Inflation.

Although the Company has not attempted to calculate the effect of inflation, management does not believe inflation has had a material effect on its results of operations.

ITEM 3. CONTROLS AND PROCEDURES

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this report. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures are effective.

In connection with the evaluation of the Company's internal controls during the Company's last fiscal quarter, the Company's Chief Executive Officer and Chief Financial Officer have determined that there are no changes to the Company's internal controls over financial reporting that has materially affected, or is reasonably likely to materially effect, the Company's internal controls over financial reporting.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

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On December 14, 2001, we initiated a proceeding in The Circuit Court of the Nineteenth Judicial Circuit in and for Martin County, Florida, case number 01-1087-CA against Larry J. Horbach, individually and L.J. Horbach & Associates. Larry Horbach was a former interim CFO and Board member. We claim that Larry Horbach, without appropriate authority, borrowed \$100,050 from Mid City Bank in the name of Regency. We further claim that Horbach converted all or part of the proceeds from the loan for his benefit and breached his fiduciary duties as an officer and director. Horbach filed a Motion for the Court to determine whether the claims asserted against him were properly brought in Florida, or whether they should have been filed in Nebraska. The matter was fully briefed, and the Florida Court took the matter under advisement. The Florida Court has not yet rendered its decision on this jurisdictional issue.

On February 7, 2002, a complaint naming Regency as defendant was filed in the District Court of Douglas County, Nebraska, case number 1012. The Plaintiffs are Larry J. Horbach, individually and L.J. Horbach & Associates and they are demanding payment on a loan they purchased from Mid City Bank. The plaintiffs are requesting payment of \$82,512.57 plus accrued interest, costs and attorney fees. We are vigorously defending this litigation.

On May 2, 2002, a lawsuit (the "Federal Action") was filed in the Federal District Court for the District of Nebraska (the "Nebraska Court") by two dissident Company shareholders, Edward E. Gatz and Donald D. Graham, captioned Gatz et al. v. Ponsoldt, Sr., et al, against the former officers and directors of the Company, Statesman and, as a nominal defendant only, the Company. In December 2002, plaintiffs filed a seven-count Amended Complaint to add claims against Royalty and Royalty's control persons. All Defendants moved to dismiss all claims against them on jurisdictional and substantive grounds. On July 7, 2003, the Nebraska Court ruled that venue in the District of Nebraska was improper and granted defendants' motions to transfer the case to the District of Delaware. In connection with the transfer of the case to Delaware, the Court denied as moot the other motions pending before it without prejudice to their reassertion in the United States District Court for the District of Delaware (the "Delaware Federal Court").

In September and October 2003, all defendants filed motions to dismiss the Federal Action with the Delaware Federal Court and plaintiffs filed a motion for permission to file an amended and supplemental complaint as well as a preliminary injunction or status quo order seeking, among other things, to prevent the Company from taking any actions outside the ordinary course of business. On December 18, 2003, the Delaware Federal Court issued an opinion and order which, among other things (i) granted defendants' motions to dismiss the amended complaint with respect to certain claims, (ii) denied plaintiffs' motion for leave to file a supplemental and second amended complaint, (iii) denied plaintiffs' request for a preliminary injunction and a status quo order and (iv) dismissed the remainder of the amended complaint for lack of subject matter jurisdiction. As a result of the Delaware Federal Court's opinion and order, the Federal Action was dismissed in its entirety.

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ITEM 1. LEGAL PROCEEDINGS. (continued)

On January 20, 2004, a purported derivative and class action lawsuit (the "Delaware State Action") was filed by the same two individual shareholder plaintiffs in the New Castle County Court of Chancery, Delaware, captioned Gatz et al. v. Ponsoldt, Sr., et al, (C.A. No. 174-N) naming as defendants certain current and former directors of the Company, Royalty and certain of its affiliates, Statesman and, nominally, the Company. The complaint alleges, among other things, breaches of fiduciary duties by the former director defendants and Statesman in connection with (i) the exercise by Statesman in 2001 of an option to acquire shares of our common stock, (ii) the 2001 sale of Aggregate by NRDC to Iron Mountain and (iii) the October 2002 Restructuring Transactions. The complaint also alleges breaches of fiduciary duties by the current director defendants in connection with the payment by the Company in 2003 of accrued compensation owed to William R. Ponsoldt, Sr. for periods prior to the October 2002 Restructuring Transactions. The complaint also alleges that Royalty and its affiliates knowingly participated in the breaches of fiduciary duties by the former director defendants relating to the October 2002 Restructuring Transactions. In addition to other damages, plaintiffs seek unspecified compensatory and/or rescissory damages against all defendants, a declaration that all Company stock issued to Statesman, William R. Ponsoldt, Sr., Royalty and any person affiliated with the foregoing is void, an order rescinding any payments in any form made by the Company to William R. Ponsoldt, Sr. or any of his affiliates or family members, an order rescinding the October 2002 Restructuring Transactions, and an order rescinding Statesman's 2001 option exercise and rescinding the option itself. The Company, as a nominal defendant, has not taken any position with respect to the merits of the Delaware State Action. Each of the other defendants has moved to dismiss the Delaware State Action and these motions are pending.

The defendants in the Federal Action and the Delaware State Action, other than Statesman, are entitled to be indemnified by the Company for damages, if any, and expenses, including legal fees, they may incur as a result of the lawsuit, subject to certain circumstances under which such indemnification is not available. In addition, other than with respect to the claims against the current director defendants in their capacities as such, the claims contained in the Delaware State Action are not covered by insurance, as the Company's carrier has declined coverage on the basis of the "insured vs. insured" exclusion since one of the named plaintiffs, Donald D. Graham, was previously a director of the Company. The Company submitted a claim to its carrier with respect to the claims in the Delaware State Action against the current director defendants the carrier has denied the Company's claim.

On May 10, 2004, Gary Nuttall, a former President of the Company, commenced an arbitration against the Company with respect to certain claims allegedly arising under his 1995 Employment Agreement with the Company. He is seeking severance and all other compensation and benefits due him under the 1995 Employment Agreement in an amount in excess of approximately \$1,650,000 (\$1,400,000 of which is a financing bonus), 466,667 unrestricted shares of the Company (pre-split), options to purchase additional stock of the Company, punitive damages, interest, fees and costs associated with the arbitration. The Company believes the claims are without merit and intends to defend them vigorously.

ITEM 2. CHANGES IN SECURITIES AND SMALL BUSINESS ISSUER PURCHASES OF EQUITY

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SECURITIES.

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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Regency Affiliates, Inc. and Subsidiaries

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

None.

ITEM 5. OTHER INFORMATION.

None

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K.

EXHIBIT AND REPORT INDEX

(a) Exhibits

| Exhibit Number ----- | Description of Exhibit ----- |
|-------------------------|--|
| 3.1(i)(a) | Restated Certificate of Incorporation of the Company (filed as Exhibit 3.1(i)(a) to the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2002, filed on November 19, 2002, and incorporated herein by reference). |
| 3.1(i)(b) | Corrected Certificate of Amendment reflecting amendment to Restated Certificate of Incorporation of the Company (filed as Exhibit 3.1(i)(b) to the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2002, filed on November 19, 2002, and incorporated herein by reference). |
| 3.1(i)(c) | Certificate of Amendment of Restated Certificate of Incorporation of Regency Affiliates, Inc. (filed as Exhibit A to the Company's Information Statement on Schedule 14C filed on October 27, 2003 and incorporated by reference herein). |
| 3.1(i)(d) | Certificate of Designation - Series B Preferred Stock, \$10 Stated Value, \$.10 par value (filed as Exhibit to Form 10-K dated June 7, 1993 and incorporated herein by reference). |
| 3.1(i)(e) | Amended and Restated Certificate of Designation, Series C Preferred Stock, \$100 Stated Value, \$.10 par value (filed as Exhibit 99.4 to the Company's Current Report |

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on Form 8-K filed on October 18, 2002, and incorporated herein by reference).

- 3.1(i)(f) Certificate of Designation - Series D Junior Preferred Stock, \$10 Stated Value, \$.10 par value (filed as Exhibit to Form 10-K dated June 7, 1993 and incorporated herein by reference).
- 3.1(i)(g) Certificate of Designation - Series E Preferred Stock, \$100 Stated Value, \$.10 par value (filed as Exhibit 4.1 to the Company's Annual Report on Form 10-K for the year ended December 31, 1995 at page E-1, and incorporated herein by reference).
- 3.1(ii)(a) By-laws of the Company (filed as Exhibit 3.4 to the Company's Registration Statement on Form S-1, Registration Number 2-86906, and incorporated herein by reference).
- 3.1(ii)(b) Amendment No. 1 to By-Laws of the Company (filed as Exhibit 3.1(ii)(b) to the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2002, filed on November 19, 2002, and incorporated herein by reference).
- 10.1 Amendment No. 2 to 2003 Stock Incentive Plan, as amended.*
- 10.2 Stock Option Agreement, dated as of August 13, 2004 between the Company and Laurence S. Levy.*
- 10.3 Stock Option Agreement, dated as of August 13, 2004 between the Company and Neil Hasson.*
- 31.1 Chief Executive Officer's Certificate, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.*
- 31.2 Chief Financial Officer's Certificate, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.*
- 32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. *
- 32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.*
- 99.1 Report of the Special Committee of the Company's Board of Directors, dated May 10, 2003, and adopting resolutions (filed as Exhibit 99.2 to Company's Quarterly Report on Form 10-Q for the period ended March 31, 2003, and incorporated by reference herein).

* Filed herewith

(b) Reports on Form 8-K

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| Date ---- | Items Reported ----- | Financial Statements ----- |
|---|-------------------------|-------------------------------|
| May 11, 2004, as amended by Amendment No. 1 thereto dated July 16, 2004, and further amended by Amendment No. 2 thereto dated August 13, 2004 | 2 | None |

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SIGNATURES

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

REGENCY AFFILIATES, INC.
(Registrant)

Date: August 23, 2004

/s/ Laurence S. Levy

(President and Chief Executive Officer)

Date: August 23, 2004

/s/ Neil N. Hasson

(Chief Financial Officer)

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EXHIBIT AND REPORT INDEX

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* Filed herewith

(b) Reports on Form 8-K

| Date ----- | Item Reported ----- | Financial Statement ----- |
|---|------------------------|------------------------------|
| May 11, 2004, as amended by Amendment No. 1 thereto dated July 16, 2004, and further amended by Amendment No. 2 thereto dated August 13, 2004 | 2 | None |

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