

Edgar Filing: North Atlantic Holding Company, Inc. - Form 10-Q

North Atlantic Holding Company, Inc.  
Form 10-Q  
November 14, 2005

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20459

FORM 10-Q

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

For the quarterly period ended September 30, 2005 or

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

Commission File Number 333-115587

NORTH ATLANTIC HOLDING COMPANY, INC.

-----  
(Exact Name of Registrant as Specified in Its Charter)

DELAWARE

20-0709285

-----  
(State or Other Jurisdiction of  
Incorporation or Organization)

-----  
(I.R.S. Employer  
Identification No.)

257 Park Avenue South, New York, New York

10010-7304

-----  
(Address of Principal Executive Offices)

-----  
(Zip Code)

(212) 253-8185

-----  
(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 is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No .

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 589,176 shares of common stock, \$.01 par value, as of November 12, 2005.

PART I  
FINANCIAL INFORMATION

Item 1. Financial Statements

NORTH ATLANTIC HOLDING COMPANY, INC. AND SUBSIDIARIES

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CONDENSED CONSOLIDATED BALANCE SHEETS  
(in thousands except share data)  
(unaudited)

	September 30, 2005
	-----
Current assets:	
Cash	\$ 4,582
Accounts receivable, net	7,431
Inventories	33,500
Other current assets	4,041
	-----
Total current assets	49,554
Property, plant and equipment, net	14,190
Deferred financing costs, net	13,096
Goodwill	128,697
Other intangible assets, net	9,962
Other assets	18,011
	-----
Total assets	\$ 233,510
	=====
Current liabilities:	
Accounts payable	\$ 5,253
Accrued expenses	6,639
Accrued interest expense	1,738
Deferred income taxes	4,141
Revolving credit facility	-
	-----
Total current liabilities	17,771
Senior notes and long-term debt	272,790
Term loan	30,000
Deferred income taxes	5,869
Postretirement benefits	6,471
Pension benefits and other long-term liabilities	3,293
	-----
Total liabilities	336,194
	-----
Stockholder's equity:	
Common stock, voting, \$.01 par value authorized shares, 750,000; issued shares, 591,343, outstanding shares, 589,176, shares held in treasury, 2,167 in 2005; and issued and outstanding, 591,343 in 2004	6
Additional paid-in capital	5,381
Loans to stockholders for stock purchase	(97)

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Accumulated other comprehensive income (loss)	(1,364)
Accumulated deficit	(106,610)
	-----
Total stockholders' equity (deficit)	(102,684)
	-----
Total liabilities and stockholders' deficit	\$ 233,510
	=====

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

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NORTH ATLANTIC HOLDING COMPANY, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
(in thousands except per share amounts)  
(unaudited)

	Three months Ended September 30, 2005	
	-----	-----
Net sales	\$ 28,847	\$
Cost of sales	14,204	
	-----	-----
Gross profit	14,643	
Selling, general and administrative expenses	8,564	
Restructuring charges	853	
	-----	-----
Operating income (loss)	5,226	
Interest expense and financing costs, net	7,781	
Other expense	851	
	-----	-----
Income (loss) before income tax expense (benefit)	(3,406)	
Income tax expense (benefit)	572	
	-----	-----
Net income (loss) applicable to common shares	\$ (3,978)	\$
	=====	=====
Basic earnings per common share:		
Net income (loss) applicable to common shares	\$ (6.75)	\$
	=====	=====
Diluted earnings per common share:		
Net income (loss) applicable to common shares	\$ (6.75)	\$
	=====	=====

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Weighted average common shares outstanding:	
Basic	589.3
Diluted	589.3

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

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NORTH ATLANTIC HOLDING COMPANY, INC. AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
 (in thousands except per share amounts)  
 (unaudited)

	Nine months Ended September 30, 2005	Sep
	-----	-----
Net sales	\$ 86,716	\$
Cost of sales	42,466	-----
Gross profit	44,250	-----
Selling, general and administrative expenses	29,393	-----
Restructuring charges	4,920	-----
Operating income (loss)	9,937	-----
Interest expense and financing costs, net	23,149	-----
Other expense	2,451	-----
Income (loss) before income tax expense (benefit)	(15,663)	-----
Income tax expense (benefit)	575	-----
Net income (loss)	(16,238)	-----
Preferred stock dividends	-	-----
Net income (loss) applicable to common shares	\$ (16,238)	\$ =====
Basic and Diluted earnings per common share:		
Net income (loss)	\$ (27.55)	\$
Preferred stock dividends	-	-----
Net income (loss) applicable to common shares	\$ (27.55)	\$ =====

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Common stock dividends	\$	-	\$
	=====		=====
Basic and Diluted earnings per common share:			
Common stock dividends	\$	-	\$
	=====		=====
Weighted average common shares outstanding:			
Basic		589.3	
Diluted		589.3	

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

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NORTH ATLANTIC HOLDING COMPANY, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)  
(in thousands)  
(unaudited)

		Three months Ended September 30, 2005	
		-----	Se
Net income (loss)	\$	(3,978)	\$
Other comprehensive income:			
Unrealized hedging gains (losses)		(13)	
		-----	---
Comprehensive income (loss)	\$	(3,991)	\$
		=====	=====
		Nine months Ended September 30, 2005	
		-----	S
Net income (loss)	\$	(16,238)	\$
Other comprehensive income:			
Unrealized hedging gains (losses)		(13)	
		-----	---
Comprehensive income (loss)	\$	(16,251)	\$
		=====	=====

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

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NORTH ATLANTIC HOLDING COMPANY, INC. AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
 (in thousands)  
 (unaudited)

	Nine months Ended September 30, 2005
	-----
Cash flows from operating activities:	
Net income (loss)	\$ (16,238)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:	
Loss on disposal of equipment	600
Other comprehensive income	(13)
Depreciation	655
Amortization of other intangible assets	331
Amortization of deferred financing costs	1,817
Amortization of interest on senior discount notes	6,168
Deferred income taxes	204
Stock compensation expense	90
Changes in operating assets and liabilities:	
Accounts receivable, net	408
Inventories	4,459
Other current assets	1,820
Other assets	(2,485)
Accounts payable	(1,752)
Accrued expenses and other	(2,539)
Accrued pension liabilities & other long-term	(720)
Accrued postretirement liabilities	410
	-----
Net cash provided by (used in) operating activities	(6,785)
	-----
Cash flows from investing activities:	
Net additions to plant, property and equipment	(4,674)
	-----
Net cash provided by (used in) investing activities	(4,674)
	-----
Cash flows from financing activities:	
Proceeds from term loan	30,000
Proceeds (payments) from (to) revolving credit facility	(14,500)
Proceeds from issuance of new senior notes	-
Proceeds from issuance of senior discount notes	-
Payment of old senior notes	-
Payment of financing costs	(1,808)
Payments on notes payable	-
Redemption of preferred stock	-
Preferred stock cash dividends	-
Proceeds from issuance of common stock	-
Common stock cash dividend	-
Loan repayments from stockholders for stock purchases	2

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Net cash provided by (used in) financing activities	13,694
Net increase (decrease) in cash	2,235
Cash, beginning of period	2,347
Cash, end of period	\$ 4,582

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

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North Atlantic Holding Company, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

1. RESTATEMENT OF CONSOLIDATED FINANCIAL STATEMENTS

North Atlantic Holding Company, Inc. (the "Company") previously restated its consolidated financial statements to correct an error in accounting for income taxes. During the fourth quarter of 2004, the Company and its subsidiaries provided a full valuation allowance against its net deferred tax assets. Following a review of the Company's deferred tax assets and deferred tax liabilities, the Company determined that in calculating the valuation allowance, deferred tax liabilities relating to inventories and tax-deductible goodwill had been inappropriately netted against certain deferred tax assets. It cannot be determined that the temporary differences related to inventories and goodwill will reverse during the time period in which the Company's temporary differences related to its deferred tax assets are expected to reverse or expire. Therefore, these deferred tax liabilities should not have been utilized to reduce the amount of the valuation allowance against deferred tax assets. This resulted in an understatement of the valuation allowance in the amount of these deferred tax liabilities of \$9.8 million and \$10.0 million as of December 31, 2004 and March 31, 2005, respectively, and an understatement of income tax expense of \$9.8 million and \$0.2 million for the year ended December 31, 2004 and for the three months ended March 31, 2005, respectively. The correction of this understatement has the effect of increasing deferred tax liabilities, increasing accumulated deficit and decreasing net income, with no effect on net cash flows, as of and for the year ended December 31, 2004 and as of and for the three months ended March 31, 2005.

The following table represents the effect of the restatement on the Company's Consolidated Balance Sheet as of December 31, 2004:

CONSOLIDATED BALANCE SHEET AS OF DECEMBER 31, 2004

	As Previously Reported	Adjustment
Deferred income taxes - current	\$ -	\$ 4,801
Deferred income taxes - non-current	\$ -	\$ 5,005
Accumulated deficit	\$ (80,566)	\$ (9,806)

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### 2. ORGANIZATION

These condensed consolidated financial statements should be read in conjunction with the financial statements and related notes thereto included in the Company's Annual Report on Form 10-K, as amended, for the year ended December 31, 2004.

The accompanying condensed consolidated financial statements are presented in accordance with the requirements of Form 10-Q and, accordingly, do not include all the disclosures normally required by generally accepted accounting principles. The condensed consolidated financial statements have been prepared in accordance with the Company's customary accounting practices and have not been audited. In the opinion of management, all adjustments necessary to fairly present the results of operations for the reported interim periods have been recorded and were of a normal and recurring nature. The year-end balance sheet data, as restated and described in Note 1 above, was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles.

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On February 9, 2004, North Atlantic Trading Company, Inc., a Delaware corporation ("NATC"), consummated a holding company reorganization whereby the Company became the parent company of NATC. The holding company reorganization was effected pursuant to an Agreement and Plan of Merger (the "Merger Agreement"), dated February 9, 2004, among the Company, NATC and NATC Merger Sub, Inc., a Delaware corporation and a direct wholly-owned subsidiary of the Company ("Merger Sub").

Pursuant to the Merger Agreement, (i) Merger Sub was merged with and into NATC (the "Merger"), with NATC as the surviving corporation; (ii) NATC became a wholly-owned subsidiary of the Company; (iii) each of the 539,235 issued and outstanding shares of voting common stock of NATC, par value \$0.01 per share, was converted into the right to receive one share of common stock of the Company, par value \$0.01 per share ("Company Common Stock"); (iv) each issued and outstanding share of common stock of Merger Sub was converted into one issued and outstanding share of common stock of NATC, par value \$0.01 per share ("NATC Common Stock"); and (v) all of the issued and outstanding shares of the Company's Common Stock held by NATC were cancelled.

Immediately after the Merger, (i) 539,235 shares of Company Common Stock were issued and outstanding; and (ii) ten (10) shares of NATC Common Stock were issued and outstanding.

Subsequently, the Company issued 49,523 shares of Company Common Stock upon the exercise of certain warrants pursuant to a Warrant Agreement (the "Warrant Agreement"), dated June 25, 1997, between the Company (as assignee to NATC's rights and obligations under the Warrant Agreement) and The Bank of New York, as warrant agent (as successor to the United States Trust Company of New York). As of September 30, 2005, (i) 591,343 shares of Company Common Stock were issued and 589,176 were outstanding; and (ii) ten (10) shares of NATC Common Stock were issued and outstanding.

### 3. RECAPITALIZATION AND REORGANIZATION

On February 9, 2004, NATC consummated its general corporate reorganization in which the Company was created and became the parent company of NATC. On February



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17, 2004, NATC consummated the refinancing of its existing debt and preferred stock and the Company issued senior discount notes in conjunction with the refinancing. The refinancing consisted principally of (1) the offering and sale of \$200.0 million principal amount of 9 1/4% senior notes due 2012 by NATC (the "New Senior Notes"), (2) the entering into by NATC of an amended and restated loan agreement (the "Old Credit Agreement") that provided a \$50.0 million senior secured revolving credit facility (the "Senior Revolving Credit Facility") to NATC (see Note 8 for a discussion of the refinancing of the Senior Revolving Credit Facility), and (3) the concurrent offering and sale of \$97.0 million aggregate principal amount at maturity of 12 1/4% senior discount notes due 2014 of the Company (the "Company Notes"). Both the New Senior Notes and the Company Notes were offered pursuant to Rule 144A and Regulation S and subsequently registered under the Securities Act of 1933, as amended.

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Concurrently with the closing of the refinancing, NATC also called for the redemption of all its outstanding 11% senior notes due 2004 (the "Old Senior Notes"), in accordance with the terms of the indenture governing such notes, at the applicable redemption price of 100.0% of the principal amount of \$155.0 million, plus interest accrued to the redemption date of April 2, 2004.

The proceeds from the offering of the New Senior Notes, along with borrowings under the Senior Revolving Credit Facility (see Notes 7 and 8) and the proceeds from the concurrent offering of the Company Notes were used to (1) repay \$36.6 million in outstanding borrowings under the existing senior credit facility (the "Old Senior Credit Facility"), including borrowings used to finance the cash purchase price for the acquisition of Stoker, Inc., (2) redeem the Old Senior Notes, (3) redeem NATC's existing 12% senior exchange payment-in-kind preferred stock on March 18, 2004, (4) pay a \$4.9 million pro rata distribution to stockholders of the Company and make a distribution to certain holders of warrants of the Company, (5) make \$2.1 million in incentive payments to certain key employees and outside directors, and (6) pay fees and expenses of \$12.8 million incurred in connection with the offerings.

#### 4. RESTRUCTURING

In January 2005, the Company engaged the management consulting firm of Alvarez and Marsal, LLC ("A&M") to identify the potential for performance improvement opportunities and to provide for the services of Douglas P. Rosefsky as Chief Financial Officer.

In April 2005, the Company appointed Douglas P. Rosefsky (formerly Chief Financial Officer) as President and Chief Executive Officer, Thomas F. Helms, Jr. (formerly Chairman of the Board of Directors, President and Chief Executive Officer) as Executive Chairman of the Board of Directors, and Brian C. Harriss as Chief Financial Officer.

In June 2005, NATC appointed Lawrence S. Wexler (President of the Company's North Atlantic Cigarette Company, Inc., subsidiary) as Chief Operating Officer.

For the nine months ended September 30, 2005, total restructuring charges amounted to approximately \$4.9 million, including, but not limited to, severance and separation expenses, A&M fees and other non-recurring expenses. The Company anticipates incurring additional expenses relating to the restructuring during the remainder of 2005 and 2006.

#### 5. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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**BASIS OF PRESENTATION:** For the three and nine months ended September 30, 2005, the condensed consolidated financial statements include the accounts of the Company and its subsidiaries. For the three and nine months ended September 30, 2004, the condensed consolidated statement of operations includes the accounts of the Company from inception (February 9, 2004) through September 30, 2004 and the accounts of NATC and its subsidiaries for January 1, 2004 through September 30, 2004. All significant intercompany accounts have been eliminated.

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**REVENUE RECOGNITION:** The Company recognizes revenues and the related costs upon transfer of title and risk of loss to the customer. **Shipping Costs:** The Company records shipping costs incurred as a component of selling, general and administrative expenses. Shipping costs incurred were \$0.7 million and \$0.9 million for the three months ended September 30, 2005 and 2004, respectively, and \$3.0 million and \$2.6 million for the nine months ended September 30, 2005 and 2004, respectively.

**FINANCIAL INSTRUMENTS:** The Company enters into foreign currency forward contracts to hedge a portion of its exposure to changes in foreign currency exchange rates on inventory purchase commitments. The Company accounts for its forward contracts under the provisions of Statement of Financial Accounting Standards No. 133 (SFAS 133), "Accounting for Derivative Instruments and Hedging Activities." The Company may hedge up to eighty percent of its anticipated purchases of inventory under the Bollore, S.A. master contract, denominated in Euros, over a forward period not to exceed twelve months. The Company may also, from time to time, hedge up to ninety percent of its non-inventory purchases in the denominated invoice currency. Forward contracts that qualify as hedges are adjusted to their fair value through other comprehensive income as determined by market prices on the measurement date. As of September 30, 2005, the adjustment to record the decrease in fair value relating to the forward contracts amounted to \$13,000 and is recorded as other comprehensive income. Gains and losses on these contracts are transferred from other comprehensive income into net income as the related inventories are sold. Changes in fair value of any contracts that do not qualify for hedge accounting or are not designated as hedges are recognized in income currently.

**MASTER SETTLEMENT AGREEMENT ESCROW ACCOUNT:** Pursuant to the Master Settlement Agreement (the "MSA") entered into in November 1998 by most states (represented by their attorneys general acting through the National Association of Attorneys General) and subsequent states' statutes, a "cigarette manufacturer" (which is defined to include a manufacturer of make-your-own cigarette tobacco) has the option of either becoming a signatory to the MSA or opening, funding, and maintaining an escrow account to have funds available for certain potential tobacco-related liabilities, with sub-accounts on behalf of each settling state. The Company has chosen to open and fund an escrow account as its method of compliance. It is the Company's policy to record amounts on deposit in the escrow account for prior years, as well as cash-on-hand to fund its projected deposit based on its monthly sales for the current year, as an Other non-current asset. Each year's obligation is required to be deposited in the escrow account by April 15 of the following year. During April 2005, approximately \$3.4 million relating to 2004 sales was deposited. As of September 30, 2005 and December 31, 2004, the Company has recorded approximately \$16.4 million and \$13.2 million, respectively, in Other assets. For the nine months ended September 30, 2005, approximately \$2.5 million relating to 2005 sales was recorded in Other assets.

### 6. INVENTORIES

Inventories are stated at the lower of cost or market. Cost is determined on the last-in, first-out ("LIFO") method for approximately 96% of the inventories.

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Leaf tobacco is presented in current assets in accordance with standard industry practice, notwithstanding the fact that such tobaccos are carried longer than one year for the purpose of curing.

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For the three and nine months ended September 30, 2005, inventory quantities were reduced. This reduction resulted in a liquidation of LIFO inventory quantities carried at higher costs prevailing in prior years as compared with the cost of 2005 purchases, the effect of which increased cost of goods sold and decreased net income by approximately \$0.3 million and \$1.0 million, respectively, as compared to \$0.9 million and \$0.5 million for the three and nine months ended September 30, 2004, respectively.

The components of inventories are as follows (in thousands):

	9/30/2005	12/31/04
	-----	-----
Raw materials and work in process	\$ 3,738	\$ 4,246
Leaf tobacco	6,714	7,878
Finished goods - loose leaf tobacco	3,373	3,069
Finished goods - MYO products	7,486	8,539
Other	1,900	2,163
	-----	-----
	23,211	25,895
LIFO reserve	10,289	12,064
	-----	-----
	\$ 33,500	\$ 37,959
	=====	=====

### 7. COMPANY NOTES AND NEW SENIOR NOTES

The outstanding amounts of the Company Notes and New Senior Notes are as follows (in thousands):

	9/30/2005	12/31/04
	-----	-----
Company Notes	\$ 72,790	\$ 66,622
New Senior Notes	200,000	200,000
	-----	-----
	\$ 272,790	\$ 266,622
	=====	=====

On February 17, 2004, NATC consummated the refinancing of its existing debt and preferred stock. The refinancing consisted principally of (1) the offering and sale of the New Senior Notes, (2) entering into the Senior Revolving Credit Facility, (3) the concurrent sale of the Company Notes and (4) the repayment of \$30.7 million in debt relating principally to the acquisition of Stoker, Inc.

The New Senior Notes are senior unsecured obligations of NATC, which has no independent assets or operations, and will mature on March 1, 2012. The New Senior Notes bear interest at the rate of 9 1/4% per annum, payable semiannually on March 1 and September 1 of each year, commencing on September 1, 2004. Each of NATC's existing subsidiaries jointly, severally and fully and unconditionally guarantees the New Senior Notes on a senior unsecured basis. Each of NATC's future subsidiaries (other than those designated unrestricted subsidiaries) will jointly and severally guarantee the New Senior Notes on a senior unsecured basis. NATC is not required to make mandatory redemptions or sinking fund payments prior to the maturity of the New Senior Notes. The Company or NATC may,

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from time to time, seek to retire all or a portion of the New Senior Notes through cash purchases and/or exchanges for other securities in open market purchases, privately negotiated transactions or otherwise.

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On and after March 1, 2008, the New Senior Notes will be redeemable, at NATC's option, in whole at any time or in part from time to time, upon not less than 30 nor more than 60 days prior notice at the following redemption prices (expressed in percentages of principal amount), if redeemed during the 12-month period commencing March 1 of the years set forth below, plus accrued and unpaid interest to the redemption date (subject to the right of holders of record on the relevant record date to receive interest due on the relevant interest payment date):

Year	Redemption Price
----	-----
2008	104.625%
2009	102.313%
2010 and thereafter	100.000%

In addition, prior to March 1, 2008, NATC may redeem the New Senior Notes, at its option, in whole at any time or in part from time to time, upon not less than 30 nor more than 60 days prior notice at a redemption price equal to 100% of the principal amount of the New Senior Notes redeemed plus a "make-whole" premium based on U.S. Treasury rates as of, and accrued and unpaid interest to, the applicable redemption date.

Further, at any time prior to March 1, 2007, NATC may, at its option, redeem up to 35% of the aggregate principal amount of the New Senior Notes with the net cash proceeds of one or more equity offerings by the Company or NATC, at its option, subject to certain conditions, at a redemption price equal to 109.250% of the principal amount thereof, plus accrued and unpaid interest thereon, if any, to the date of redemption; provided, however, that after any such redemption at least 65% of the aggregate principal amount of the New Senior Notes remains outstanding. In order to affect the foregoing redemption with the proceeds of any equity offering, NATC shall make such redemption not more than 60 days after the consummation of any such equity offering.

Concurrently with the offering of the New Senior Notes, the Company issued \$97.0 million aggregate amount at maturity of the Company Notes. Proceeds of approximately \$53.8 million from this issuance were used to make a capital contribution to NATC. The Company Notes are the Company's senior obligations and are unsecured. Prior to March 1, 2008, interest will accrue on the Company Notes in the form of an increase in the accreted value of the Company Notes. Thereafter, cash interest on the Company Notes will accrue and be payable semi-annually in arrears on March 1 and September 1, commencing on September 1, 2008, at a rate of 12 1/4% per annum. The Company Notes were issued with an initial accreted value of \$618.66 per \$1,000 principal amount of maturity of Company Notes. The accreted value of each Company Note will increase from the date of issuance until March 1, 2008, at a rate of 12 1/4% per annum, compounded semi-annually reflecting the accrual of non-cash interest, such that the accreted value will equal the principal amount at maturity of each Company Note on March 1, 2008. The Company Notes are not guaranteed by NATC or any of its subsidiaries and are structurally subordinated to all of NATC's and its subsidiaries' obligations, including the New Senior Notes and the Financing Agreement (see Note 8). The Company is not required to make mandatory redemptions or sinking fund payments prior to the maturity of the Company Notes.

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On and after March 1, 2009, the Company Notes will be redeemable, at the Company's option, in whole at any time or in part from time to time, upon not less than 30 nor more than 60 days prior notice at the following redemption prices (expressed in percentages of principal amount at maturity), if redeemed during the 12-month period commencing March 1 of the years set forth below, plus accrued and unpaid interest to the redemption date (subject to the right of holders of record on the relevant record date to receive interest due on the relevant interest payment date):

Year	Redemption Price
----	-----
2009	106.125%
2010	104.083%
2011	102.042%
2012 and thereafter	100.000%

In addition, prior to March 1, 2009, the Company may redeem the Company Notes, at its option, in whole at any time or in part from time to time, upon not less than 30 nor more than 60 days prior notice at a redemption price equal to 100% of the accreted value of the Company Notes redeemed plus a "make-whole" premium based on U.S. Treasury rates as of, and accrued and unpaid interest to, the applicable redemption date.

Further, at any time prior to March 1, 2007, the Company may, at its option, redeem up to 35% of the aggregate principal amount at maturity of the Company Notes with the net cash proceeds of one or more equity offerings by the Company or NATC, subject to certain conditions, at a redemption price equal to 112.250% of the accreted value thereof, plus accrued and unpaid interest thereon, if any, to the date of redemption; provided, however, that after any such redemption at least 65% of the aggregate principal amount at maturity of the Company Notes remains outstanding. In order to affect the foregoing redemption with the proceeds of any equity offering, the Company shall make such redemption not more than 60 days after the consummation of any such equity offering.

On October 6, 2005, NATC purchased Company Notes with an accreted book value of approximately \$22.1 million (face value at maturity of approximately \$29.5 million) for approximately \$6.3 million in cash. The Company or NATC may, from time to time, continue to acquire and/or retire all or a portion of the Company Notes and/or New Senior Notes through cash purchases and/or exchanges for other securities in open market purchases, privately negotiated transactions or otherwise.

The Company is dependent on NATC's cash flows to service its debt. The amount of cash interest to be paid by the Company to third parties during the next five years is as follows: \$0 in each of 2005, 2006, 2007 and March 1, 2008; \$4,137 payable on September 1, 2008 and \$4,137 payable on each of March 1 and September 1 thereafter, until maturity.

### 8. FINANCING AGREEMENT

On June 16, 2005, NATC refinanced its existing \$35.0 million Amended and Restated Loan Agreement, dated as of February 17, 2004, by entering into a Financing Agreement (the "Financing Agreement") with various financial institutions ("Lenders") and Fortress Credit Corp., as agent for the Lenders

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("Agent"). The Financing Agreement consists of a \$30.0 million term loan facility and a \$55.0 million revolving credit facility, and includes a letter of credit sublimit of \$10.0 million (collectively, the "Credit Facility"). As of

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September 30, 2005, NATC had not borrowed any monies under the revolving credit facility. The Credit Facility will mature on June 30, 2010, and does not provide for any amortization of the term loan prior to maturity. NATC will use the revolving credit facility for working capital requirements and other general corporate purposes. Indebtedness under the Financing Agreement is guaranteed by the Company and each of NATC's current and future subsidiaries, and is secured by a first perfected lien on substantially all of the Company's and its direct and indirect subsidiaries' current and future assets and property. The collateral includes a pledge by the Company of its equity interest in NATC and a first priority lien on all equity interests and intercompany notes held by NATC and its direct and indirect subsidiaries.

Loans and advances under the Financing Agreement bear interest at a variable rate based on either the prime rate or LIBOR, at NATC's option, plus a specified margin ranging from 1.00% to 3.75% in case of prime rate indebtedness, and from 3.50% to 6.25% in the case of LIBOR indebtedness, based on the sum of NATC's secured indebtedness in relation to its EBITDAR, as defined in the Financing Agreement. As of September 30, 2005, the interest rate on NATC's term loan was 7.2%.

NATC paid the Lenders a closing fee of \$1.275 million and is required to pay the Agent a quarterly servicing fee in the amount of \$25,000. Under the revolving credit facility, NATC is required to pay the Lenders an annual commitment fee in an amount equal to 0.50% of the difference between \$40 million and the average usage of the revolving credit facility, payable on a monthly basis. NATC is also required to pay the Lenders letter of credit fees equal to 4.00% per annum multiplied by the face of amount of the letters of credit issued under the Financing Agreement, payable on the date any such letter of credit is issued. In addition, NATC is required to pay the Agent the standard charges customarily charged by the institution issuing letters of credit under the Financing Agreement in connection with the issuance, administration, amendment, payment or cancellation of any such letters of credit.

The Financing Agreement requires NATC to meet a maximum leverage ratio and a test of minimum earnings before interest, taxes, depreciation, amortization, certain cash and non-cash charges, other income and expenses and restructuring charges ("EBITDAR"). The Financing Agreement also contains covenants which, among other things, limit the incurrence of additional indebtedness, distribution of dividends, transactions with affiliates, asset sales, acquisitions, mergers, prepayments of other indebtedness, liens and encumbrances, capital expenditures, and other matters customarily restricted in such agreements. In addition, the Financing Agreement requires that the Chief Executive Officer of NATC be reasonably acceptable to the Agent and the Lenders during the term of the Credit Facility.

The Financing Agreement contains customary events of default, including payment defaults, breach of representations and warranties, covenant defaults, cross-acceleration, cross-defaults to certain other indebtedness, bankruptcy and insolvency, the occurrence of a Change of Control, as defined in the Financing Agreement, and judgment defaults. Further, it is an event of default under the Financing Agreement if an event or development occurs that results in a Material Adverse Effect (as defined in the Financing Agreement), as determined by the Agent in its reasonable business judgment. If any events of default occur and are not cured within applicable grace periods or waived, the outstanding loans may be accelerated and the Lenders' commitments may be terminated. The

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occurrence of the bankruptcy and insolvency event of default will result in the automatic termination of commitments and acceleration of outstanding loans under the Financing Agreement.

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### 9. SENIOR REVOLVING CREDIT FACILITY

In connection with the February 2004 refinancing, NATC amended and restated its prior Revolving Credit Facility, resulting in a \$50.0 million Senior Revolving Credit Facility with Bank One, N.A., as agent (the "Agent Bank"), and LaSalle Bank, National Association. The Old Credit Agreement governing the old Senior Revolving Credit Facility includes a letter of credit sublimit of \$25.0 million and was scheduled to mature three years from the closing date. NATC's intentions were to use the Senior Revolving Credit Facility for working capital and general corporate purposes. On January 19, 2005, the Old Credit Agreement was amended to reduce the old Senior Revolving Credit Facility to \$35.0 million. As of December 31, 2004, NATC had borrowed \$14.5 million under the old Senior Revolving Credit Facility.

Indebtedness under the Old Credit Agreement was guaranteed by each of NATC's current and future direct and indirect subsidiaries, and secured by a first perfected lien on substantially all of NATC's and its direct and indirect subsidiaries' current and future assets and property. The collateral included a pledge by the Company of its equity interest in NATC and a first priority lien on all equity interests and intercompany notes held by NATC and each of its subsidiaries.

Each advance under the Old Credit Agreement bore interest at variable rates based, at NATC's option, on either the prime rate plus 1% or LIBOR plus 3%. As of September 30, 2004, the interest rate on this financing was 4.8%.

Under the Old Credit Agreement, NATC was required to pay the lenders an annual commitment fee in variable amounts ranging from 0.50% to 0.65% of the difference between the commitment amount and the average usage of the facility, payable on a quarterly basis. NATC was also required to pay to the lenders letter of credit fees equal to 3.00% per annum multiplied by the maximum amount available from time to time to be drawn under such letters of credit issued under the Old Credit Agreement and to the lenders issuing letters of credit a fronting fee of 0.125% per annum multiplied by the aggregate face amount of letters of credit outstanding during a fiscal quarter plus other customary administrative, amendment, payment and negotiation charges in connection with such letters of credit.

The Old Credit Agreement required NATC and its subsidiaries to meet certain financial tests, including a minimum fixed charge coverage ratio and a minimum consolidated adjusted earnings before interest, taxes, dividends and amortization ("EBITDA"). The Old Credit Agreement also contained covenants which, among other things, limited the incurrence of additional indebtedness, dividends, transactions with affiliates, asset sales, acquisitions, mergers, prepayments of other indebtedness, liens and encumbrances and other matters customarily restricted in such agreements. In addition, the Old Credit Agreement required that certain members of executive management remain active in the day-to-day operation and management of NATC and its subsidiaries during the term of the facility.

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The Old Credit Agreement contained customary events of default, including payment defaults, breach of representations and warranties, covenant defaults,

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cross-acceleration, cross-defaults to certain other indebtedness, certain events of bankruptcy and insolvency, the occurrence of a Change in Control and judgment defaults.

On March 30, 2005, the Old Credit Agreement was amended to modify the fixed charge coverage ratio covenant, which after modification applied only to quarters ending June 30, 2005 and thereafter. The fixed charge coverage ratio definition was also amended to include any future cash equity contributions to the Company. In addition, the amendment changed the Old Credit Agreement maturity date from February 28, 2007 to January 31, 2006.

See Note 8 of the Condensed Consolidated Financial Statements for discussion of the June 16, 2005 Financing Agreement, the proceeds of which were used to refinance and terminate the Old Credit Agreement.

### 10. PROVISION FOR INCOME TAXES

The Company has determined that at September 30, 2005, its ability to realize future benefits of certain net deferred tax assets does not meet the "more likely than not" criteria in SFAS No. 109, "Accounting for Income Taxes"; therefore, a valuation allowance continues to be recorded. Deferred income tax liabilities are provided relating to inventories and tax-deductible goodwill that is not amortized for financial reporting.

### 11. PENSION AND POSTRETIREMENT BENEFIT PLANS

The components of Net Periodic Benefit Cost for the nine months ended September 30 are as follows (in thousands):

	Pension Benefits		Other Benefits	
	2005	2004	2005	
Service cost	\$ 34	\$ 221	\$ 327	\$
Interest cost	589	587	356	
Expected return of plan assets	(552)	(711)	-	
Amortization of net (gain) loss	85	91	101	
Net periodic pension cost	\$ 156	\$ 188	\$ 784	\$
	=====	=====	=====	=====

NATC has a defined benefit pension plan covering substantially all of its hourly employees. Benefits for the hourly employees' plan are based on a stated benefit per year of service, reduced by amounts earned in a previous plan.

Effective June 30, 2004 and July 31, 2004, NATC froze the defined benefit retirement plan for the respective hourly employees of its three collective bargaining units. Based upon this above decision, management believes that any future contributions will not be material.

Effective September 30, 2004, NATC terminated its postretirement benefit plan for its salaried employees. Accordingly, NATC recognized a reduction in the



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postretirement benefit plan liability of \$3,811. The Company expects to contribute approximately \$500 to its postretirement plan in 2005 for the payment of benefits. Plan contributions and benefits have amounted to \$374 for the nine months ended September 30, 2005.

12. RECONCILIATION OF INCOME (LOSS) PER COMMON SHARE  
(DOLLARS AND SHARES IN THOUSANDS, EXCEPT PER SHARE AMOUNTS):

THREE MONTHS ENDED SEPTEMBER 30, 2005  
-----

	Income (Numerator)	Shares (Denominator)
	-----	-----
Basic and Diluted:		
Net loss	(3,978)	
	-----	
Net income applicable to common shares	\$ (3,978)	589.3
	=====	=====

THREE MONTHS ENDED SEPTEMBER 30, 2004  
-----

	Income (Numerator)	Shares (Denominator)
	-----	-----
Basic:		
Net income	\$ 5,932	
	-----	
Net income applicable to common shares	\$ 5,932	591.3
	=====	=====
Diluted:		
Net income	\$ 5,932	
	-----	
Net income applicable to common shares	\$ 5,932	718.9
	=====	=====

NINE MONTHS ENDED SEPTEMBER 30, 2005  
-----

	Income (Numerator)	Shares (Denominator)
	-----	-----
Basic and Diluted:		
Net loss	(16,238)	
	-----	
Net income applicable to common shares	\$ (16,238)	589.3
	=====	=====

NINE MONTHS ENDED SEPTEMBER 30, 2004

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	Income (Numerator)	Shares (Denominator)
Basic and Diluted:		
Net income	\$ 411	
Less: preferred stock dividends	(1,613)	
	-----	
Net income applicable to common shares	\$ (1,202)	573.2
	=====	=====

On February 9, 2004, in connection with the Merger, all the common shares of NATC were cancelled and shares of the Company were issued to NATC's shareholders on a one-for-one basis.

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The earnings per share calculations are based on the weighted average number of shares of common stock outstanding during the respective periods. Common stock equivalent shares from warrants representing 63,490 shares were excluded from the computations for the three months ended September 30, 2005 and the nine months ended September 30, 2005 and 2004, respectively.

13. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In December 2004, the FASB issued SFAS No. 123R (Revised 2004), "Accounting for Stock Based Compensation" ("SFAS No. 123R"). SFAS No. 123R establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. It also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments. SFAS No. 123R eliminates the alternative to use APB 25's intrinsic value method of accounting that was provided in SFAS No. 123 as originally issued. SFAS No. 123R requires entities to recognize the cost of employee services received in exchange for awards of equity instruments based on the grant-date fair value of those awards (with limited exceptions). That cost will be recognized over the period during which an employee is required to provide service in exchange for the award or the vesting period. No compensation cost is recognized for equity instruments for which employees do not render the requisite service. A public entity will initially measure the cost of liability based service awards based on their current fair value; the fair value of those awards will be remeasured subsequently at each reporting date through the settlement date. Changes in fair value during the requisite service period will be recognized as compensation cost over that period. The provisions of SFAS No. 123R shall become effective for the Company in the first quarter of 2006 and will apply to all awards granted after December 31, 2005 and to awards modified, repurchased, or cancelled after that date. The Company is evaluating SFAS No. 123R and believes it will not have a material effect on financial results of operations.

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs - an amendment of ARB No. 43, Chapter 4," to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). SFAS No. 151 requires that items be recognized as current-period charges regardless of whether they meet the criterion of "so abnormal" that was previously stated in ARB No. 43, Chapter 4. In addition, SFAS No. 151 requires that allocation of fixed production overheads to the costs of conversion be

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based on the normal capacity of the production facilities. The provisions of this statement shall be effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company does not expect SFAS No. 151 to have a material impact on the Company's financial condition or results of operations.

In December 2004, the FASB issued two FASB Staff Positions ("FSP") regarding the accounting implications of the American Jobs Creation Act of 2004 (the "Act"). The Act provides a deduction for income from qualified domestic production activities, which will be phased in from 2005 through 2010. In return, the Act also provides for a two-year phase-out of the existing extra-territorial income exclusion ("ETI") for foreign sales. Under the guidance in FSP No. FAS 109-1, "Application of FASB Statement 109, 'Accounting for Income Taxes,' to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004," the deduction will be treated as a "special deduction" as

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described in FASB Statement No. 109. As such, the special deduction has no effect on deferred tax assets and liabilities existing at the enactment date. FSP No. FAS 109-2, "Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004," was effective for the first quarter of 2005 and had no material impact on the Company's Condensed Consolidated Financial Statements.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections - A Replacement of APB Opinion No. 20 and FASB Statement No. 3." SFAS No. 154 requires retrospective application to prior periods' financial statements for changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 also requires that retrospective application of a change in accounting principle be limited to the direct effects of the change. Indirect effects of a change in accounting principle, such as a change in non-discretionary profit-sharing payments resulting from an accounting change, should be recognized in the period of the accounting change. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company will comply with the provisions of this statement for any accounting changes or error corrections that occur after December 31, 2005.

### 14. CONTINGENCIES

#### LITIGATION WITH REPUBLIC TOBACCO

On July 15, 1998, North Atlantic Operating Company, Inc. ("NAOC") and National Tobacco Company, L.P. ("NTC"), which are subsidiaries of the Company, filed a complaint (the "Kentucky Complaint") against Republic Tobacco, Inc. and its affiliates ("Republic Tobacco") in Federal District Court for the Western District of Kentucky. Republic Tobacco imports and sells Roll-Your-Own ("RYO") premium cigarette papers under the brand names JOB and TOP as well as other brand names. The Kentucky Complaint alleges, inter alia, that Republic Tobacco's use of exclusivity agreements, rebates, incentive programs, buy-backs and other activities related to the sale of premium cigarette papers in the southeastern United States violate federal and state antitrust and unfair competition laws and that Republic Tobacco defaced and directed others to deface NAOC's point of purchase vendor displays for premium cigarette papers by covering up the ZIG-ZAG brand name and advertising material with advertisements for Republic Tobacco's RYO cigarette paper brands. The Kentucky Complaint alleges that these activities constitute unfair competition under federal and state laws.

On June 30, 1998, Republic Tobacco filed a complaint against NATC, NAOC and NTC

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in the U.S. District Court of the Northern District of Illinois (the "Illinois Complaint") and served it on NATC after the institution of the Kentucky action. In the Illinois Complaint, Republic Tobacco seeks declaratory relief with respect to NATC's claims. In addition, the Illinois Complaint alleges that certain actions taken by NATC to inform its customers of its claims against Republic Tobacco constitute tortious interference with customer relationships, false advertising, violations of Uniform Deceptive Trade Practices and Consumer Fraud Acts, defamation and unfair competition. In addition, although not included in its original complaint but in its amended complaint, Republic Tobacco alleged that NATC has unlawfully monopolized and attempted to monopolize the market on a national and regional basis for premium cigarette papers. Republic sought unspecified compensatory damages, injunctive relief and attorneys fees and costs.

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On October 20, 2000, Republic Tobacco filed a motion to dismiss, stay, or transfer the Kentucky Complaint to the Illinois Court. On December 19, 2000, the Court denied Republic Tobacco's motion, holding that it was premature. The Court noted also that it had communicated with the Court in Illinois and that it had concluded that Republic Tobacco may not be entitled to any preference on forum selection, which would ordinarily be given because it was first to file. The Kentucky complaint is still on file.

Prior to the completion of discovery, the Court dismissed Republic Tobacco's antitrust claims against NATC. After discovery was completed in 2001, both parties moved for summary judgment on the others claims. In April 2002, the District Court for the Northern District of Illinois decided the summary judgment motions by dismissing all claims of both NATC and Republic Tobacco and its affiliates, except for Republic Tobacco's claim of defamation per se against NATC, on which it granted summary judgment on liability in favor of Republic Tobacco, and a Lanham Act false advertising claim, based on the same facts as the defamation claim, for equitable relief. In February 2003, the District Court granted Republic's motion for summary judgment on NATC's counterclaim that Republic tortiously interfered with NATC's business relationships and economic advantage. The only claim that remained to be tried was Republic's Lanham Act claim and damages on the defamation claim on which the Court previously ruled that Republic could only obtain equitable relief if successful.

On July 8, 2003, following a four-day trial, an Illinois jury returned a verdict in favor of Republic on the defamation claims of \$8.4 million in general damages and \$10.2 million in punitive damages, for a total damage award of \$18.6 million. NATC recorded an \$18.8 million charge during the second quarter 2003 relating to this transaction. NATC filed post-trial motions for a new trial and, in the alternative, for a reduction of the awards. On August 1, 2003, NATC posted a judgment bond in the amount of \$18.8 million with the U.S. District Court. This was accomplished by obtaining a \$19.0 million senior secured term loan pursuant to a July 31, 2003 amendment to NATC's existing credit facility. On November 20, 2003, the court ruled that the awards were excessive and reduced the awards by approximately 60%, with the award of compensatory damages being reduced to \$3.36 million and the award of punitive damages being reduced to \$4.08 million, for a total of \$7.44 million. On December 18, 2003, Republic accepted these reduced awards. NATC reversed \$11.16 million during the fourth quarter 2003 due to this court ruling.

On January 8, 2004, NATC appealed the final judgment, including the finding of liability in this case as well as the amount of the award. On January 22, 2004, Republic filed a general notice of cross appeal and argued in its appellate briefs that the judgment should be affirmed and also asserted, in its cross-appeal, that the original judgment should be reinstated despite its acceptance of the District Court's order reducing the judgment amount.

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On September 1, 2004, the Court of Appeals issued its ruling affirming the finding of liability against NATC for defamation, but reducing the amount of the damage award to \$3.0 million. The Court of Appeals also affirmed the dismissal of NATC's antitrust claim against Republic and the dismissal of Republic's motion to re-instate the original jury award of \$18.8 million. As a result of these rulings, in October 2004 NATC received approximately \$4.5 million relating to the cash bond it had posted with the Court in 2003. This amount was included in Other income during the third quarter of 2004.

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NATC also applied to the Court of Appeals for an order awarding NATC approximately \$1.0 million for the difference in the expense of the original bond of \$18.8 million and the subsequent reduced bond of \$7.0 million and the lesser expense NATC would have incurred to bond the final \$3.0 million judgment. On November 30, 2004, the Court of Appeals ruled that the application for costs should be directed to the District Court. On December 17, 2004, NATC filed this motion with the District Court.

On August 3, 2005, the District Court issued its ruling and awarded NATC approximately \$1.1 million. This amount is not included in the condensed consolidated financial statements. On August 11, 2005, Republic Tobacco filed a notice of appeal. No briefing schedule has been established.

### LITIGATION RELATED TO COUNTERFEITING

Texas Infringing Products Litigation. In *Bollore, S.A. v. Import Warehouse, Inc.*, Civ. No. 3-99-CV-1196-R (N.D. Texas), Bollore, the Company's Licensor of ZIG-ZAG brand premium cigarette papers, obtained a sealed order allowing it to conduct a seizure of infringing and counterfeit ZIG-ZAG products in the United States. On June 7, 1999, seizures of products occurred in Michigan and Texas. Subsequently, all named defendants have been enjoined from buying and selling such infringing or counterfeit goods. Bollore and NATC negotiated settlements with all defendants. These defendants included Import Warehouse, Ravi Bhatia, Tarek Makki and Adham Makki. Those settlements included a consent injunction against distribution of infringing or counterfeit goods.

On May 18, 2001, NATC, in conjunction with Bollore and law enforcement authorities conducted raids on the businesses and homes of certain defendants previously enjoined (including Tarek Makki and Adham Makki) from selling infringing or counterfeit ZIG-ZAG brand products in the *Bollore S.A. v. Import Warehouse* litigation. Evidence was uncovered that showed that these defendants and certain other individuals were key participants in importing and distributing counterfeit ZIG-ZAG premium cigarette papers. After a two day hearing in the U.S. District Court for the Northern District of Texas, on May 30, 2001, the Court held the previously enjoined defendants in contempt of court, and enjoined the additional new defendants, including Ali Makki, from selling infringing or counterfeit ZIG-ZAG premium cigarette papers.

NATC entered into a settlement with the defendants, the principal terms of which included a cash payment, an agreed permanent injunction, the withdrawal of the defendants' appeal of the civil contempt order, an agreed judgment of \$11.0 million from the civil contempt order and an agreement to forbear from enforcing that \$11.0 million money judgment until such time in the future that the defendants violate the terms of the permanent injunction. Two of the defendants, Tarek Makki and Adham Makki, also agreed to provide complete information concerning the counterfeiting conspiracy as well as information on other parties engaged in the purchase and distribution of infringing ZIG-ZAG premium cigarette papers.

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On February 17, 2004, NATC and Bollore filed a motion in the U.S. District Court for the Northern District of Texas, which had issued the original injunctions against the infringing defendants, seeking, with respect to respondents Adham Makki, Tarek Makki and Ali Makki, to have the \$11.0 million judgment released from the forbearance agreement and to have the named respondents held in contempt of court. The motion alleged that the three respondents had trafficked in counterfeit ZIG-ZAG cigarette papers after the execution of the settlement, citing evidence that all three had been charged in the United States District Court for the Eastern District of Michigan with criminal violations of the United States counterfeiting laws by trafficking in counterfeit ZIG-ZAG cigarette papers, which trafficking occurred after the settlement agreement.

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On April 13, 2004, the Court entered an order (the "Contempt 2 Order"), finding Ali Mackie, Tarek Makki, Adham Mackie and their companies Best Price Wholesale (the "Makki Defendants") and Harmony Brands LLC in civil contempt, freezing all of their assets, releasing the July 12, 2002 Final Judgment of \$11.0 million from the forbearance agreement as to the Makki Defendants, and again referring the matter to the United States Attorney for Criminal Prosecution. Subsequent to the entry of the Contempt 2 Order, the Company settled with defendant Harmony Brands and its members for the amount of \$750,000 and the entry of a permanent injunction. The Company is seeking to execute on the outstanding \$11.0 million judgment against the remaining Makki Defendants and those efforts are currently underway.

Pursuant to the U.S. Distribution Agreement and a related agreement between Bollore and NATC, any collections on the judgments issued in the Bollore v. Import Warehouse case are to be divided evenly between Bollore and NATC after the payment of all expenses.

On February 7, 2002, Bollore, NAOC and NATC filed a motion with the District Court in the Texas action seeking to hold Ravi Bhatia and Import Warehouse Inc. in contempt of court for violating the terms of the consent order and injunction entered against those defendants. NATC alleges that Mr. Bhatia and Import Warehouse sold counterfeit goods to at least three different companies over an extended period of time. On June 27, 2003, the Court found Import Warehouse and Mr. Bhatia in contempt of court for violating an existing injunction barring those parties from distributing infringing ZIG-ZAG cigarette paper products. The Court requested that NATC and Bollore (NATC's co-plaintiff in the case) file a submission detailing the damages incurred. NATC and Bollore filed their submission on July 25, 2003 which reported and requested damages of \$2.4 million.

On July 1, 2004, the Court issued an Order awarding approximately \$2.5 million in damages to NATC for the damages incurred by NATC as a result of the Import Warehouse Defendants' civil contempt. On July 15, 2004, the Court entered a Final Judgment in that amount for which defendants Import Warehouse, Inc. and Ravi Bhatia are jointly and severally liable. After NATC and Bollore commenced collection proceedings, Import Warehouse paid NATC and Bollore an amount equal to the entire judgment plus the expenses incurred in collection. Accordingly, approximately \$1.2 million has been recorded in Other income during the third quarter of 2004. The Import Warehouse Defendants filed a notice of appeal on July 24, 2004. No briefing schedule has been established.

On September 23, 2005, in Bollore S.A. v. Beydoun, CV05-1679 S, NATC and Bollore filed a complaint in the United States District Court for the Western District of Louisiana against certain individuals and companies alleging that they had engaged in a conspiracy to manufacture and distribute counterfeit Zig-Zag cigarette papers in the United States. The complaint sought, among other things, an injunction and damages. The civil case follows the conviction on federal

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criminal counterfeiting charges of one of the alleged participants in the conspiracy.

### LITIGATION RELATED TO ALLEGED PERSONAL INJURY

West Virginia Complaints. Trial of the West Virginia complaints against the smokeless tobacco defendants has been postponed indefinitely, as described below. On October 6, 1998 NTC was served with a summons and complaint on behalf of 65 individual plaintiffs in an action in the Circuit Court of Kanawha County, West Virginia, entitled Kelly Allen, et al. v. Philip Morris Incorporated, et al. (Civil Action Nos. 98-C-2401). On November 13, 1998, NTC was served with a second summons and complaint on behalf of 18 plaintiffs in an action in the

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Circuit Court of Kanawha County, West Virginia, entitled Billie J. Akers, et al. v. Philip Morris Incorporated et al. (Civil Action Nos. 98-C-2696 to 98-C-2713). The complaints are identical in most material respects. In the Allen case, the plaintiffs have specified the defendant companies for each of the 65 cases. NTC is named in only one action. One Akers plaintiff alleged use of an NTC product, alleging lung cancer.

On September 14, 2000, NTC was served with a summons and complaint on behalf of 539 separate plaintiffs filed in Circuit Court of Ohio County, West Virginia, entitled Linda Adams, et al. v. Philip Morris Inc., et al. (Civil Action Nos. 00-C-373 to 00-C-911). Only one of these plaintiffs alleged use of a product currently manufactured by NTC. The time period during which this plaintiff allegedly used the product has not yet been specified. Thus, it is not yet known whether NTC is a proper defendant in this case.

On September 19, 2000, NTC was served with a second summons and complaint on behalf of 561 separate plaintiffs filed in Circuit Court of Ohio County, West Virginia, entitled Ronald Accord, et al. v. Philip Morris Inc., et al. (Civil Action Nos. 00-C-923 to 00-C-1483). A total of five of these plaintiffs alleged use of a product currently manufactured by NTC. One of these plaintiffs does not specify the time period during which the product was allegedly used. Another alleges use that covers, in part, a period when NTC did not manufacture the product. On motion by cigarette company defendants, this claim was dismissed on February 11, 2004, for failure to follow the case management order. Of the remaining three, one alleges consumption of a competitor's chewing tobacco from 1966 to 2000 and NTC's Beech-Nut chewing tobacco from 1998 to 2000; another alleges a twenty-four year smoking history ending in 1995 and consumption of Beech-Nut chewing tobacco from 1990 to 1995; and the last alleges a thirty-five year smoking history ending in 2000, and consumption of NTC's Durango Ice chewing tobacco from 1990 to 2000 (although Durango Ice did not come onto the market until 1999).

In November 2001, NTC was served with an additional four separate summons and complaints in actions filed in the Circuit Court of Ohio County, West Virginia. The actions are entitled Donald Nice v. Philip Morris Incorporated, et al. (Civil Action No. 01-C-479), Korene S. Lantz v. Philip Morris Incorporated, et al. (Civil Action No. 01-C-480), Ralph A. Prochaska, et al. v. Philip Morris, Inc., et al. (Civil Action No. 01-C-481), and Franklin Scott, et al. v. Philip Morris, Inc., et al., (Civil Action No. 01-C-482).

All of the West Virginia smokeless tobacco actions have been consolidated before the West Virginia Mass Litigation Panel for discovery and trial of certain issues. Trial of these matters was planned in two phases. In the initial phase, a trial was to be held to determine whether tobacco products, including all forms of smokeless tobacco, cigarettes, cigars and pipe and roll-your-own tobacco, can cause certain specified diseases or conditions. In the second

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phase, individual plaintiffs would attempt to prove that they were in fact injured by tobacco products. Fact and expert discovery in these cases has closed, however, in the cigarette cases the Court has allowed additional discovery.

The claims against NTC in the various consolidated West Virginia actions include negligence, strict liability, fraud in differing forms, conspiracy, breach of warranty and violations of the West Virginia consumer protection and antitrust acts. The complaints in the West Virginia cases request unspecified compensatory and punitive damages.

The manufacturers of smokeless tobacco products (as well as the manufacturers of cigarettes) moved to sever the claims against the smokeless tobacco manufacturer defendants from the claims against the cigarette manufacturer defendants. That motion was granted and the trial date on the smokeless tobacco claims has now been postponed indefinitely.

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The trial court has now vacated the initial trial plan in its entirety because of concerns that its provisions violated the dictates of the United States Supreme Court's decision in *State Farm Mutual Automobile Insurance Company v. Campbell*, 538 U.S. 408 (2003). A new trial plan has not yet been implemented with regard to the consolidated claims against the cigarette manufacturer defendants. The West Virginia Supreme Court has accepted review of the case management order and briefing by the parties was commenced. The claims against the smokeless tobacco manufacturer defendants remain severed and indefinitely stayed.

Minnesota Complaint. On September 24, 1999, NTC was served with a complaint in a case entitled *Tuttle v. Lorillard Tobacco Company, et al.* (Case No. C2-99-7105), brought in Minnesota. The other manufacturing defendants are Lorillard and The Pinkerton Tobacco Company. The Complaint alleges that plaintiff's decedent was injured as a result of using NTC's (and, prior to the formation of NTC, Lorillard's) Beech-Nut brand and Pinkerton's Red Man brand of loose-leaf chewing tobacco. Plaintiff asserts theories of liability, breach of warranty, fraud, and variations on fraud and misrepresentation. Plaintiff specifically requests in its complaint an amount of damages in excess of fifty thousand dollars (\$50,000) along with costs, disbursements and attorneys' fees, and ". . . an order prohibiting defendants from disseminating in Minnesota further misleading advertising and making further untrue, deceptive and/misleading statements about the health effects and/or addictive nature of smokeless tobacco products. . . ." After discovery, summary judgment motions were filed on behalf of all defendants. On March 3, 2003, the Court granted defendants' motions, dismissing all claims against all defendants and the Court has since denied the plaintiff's motion for reconsideration. Plaintiff has appealed the dismissal. Briefing has been completed. Oral argument before the Court of Appeals was held on February 11, 2004. On July 30, 2004, the Court of Appeals affirmed the dismissal of all of the claims.

In addition to the above described legal proceedings, the Company is subject to other litigation in the ordinary course of its business. The Company does not believe that any of these other proceedings will have a material adverse effect on the results of operations, financial position or cash flows of the Company.

### OTHER EMPLOYMENT MATTERS

The Company may, from time to time, have claims from and make settlements with former officers or employees.



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David I. Brunson, the former President, Chief Financial Officer and Treasurer of the Company, resigned from the Company effective January 19, 2005, at which time his employment agreement with the Company (the "Brunson Employment Agreement") was effectively terminated. Pursuant to the Brunson Employment Agreement, the Company is required to make certain severance payments to Mr. Brunson, including \$425,000, which was paid within ten business days after January 19, 2005, and an additional \$425,000 payable within the next 12 months. In addition, Mr. Brunson may become entitled to a bonus payment of up to \$725,000 relating to synergies achieved in the integration of the business of Stoker, Inc. that was acquired by the Company in 2003. Pursuant to the Brunson Employment Agreement, after the last severance payment is made, Mr. Brunson will have an option to require the Company to repurchase all or a portion of his shares of Parent at their fair market value. The Company will not be obligated to repurchase these shares if,

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upon or after the payment, it would be in default under any instrument, agreement or law by which it is bound; in this case, the repurchase may be deferred until it can be completed without such default. Similarly, the Company has an option to repurchase Mr. Brunson's shares at their fair market value. In the event the Company and Mr. Brunson are unable to agree upon the fair market value of these shares, an independent investment banking firm will be selected to determine such fair market value, in accordance with the procedure provided for by the Brunson Employment Agreement. If neither Mr. Brunson nor the Company exercise their respective options by the earliest of the fifth anniversary of the termination of Mr. Brunson's employment or the date on which the Company refinances, or uses proceeds derived from refinancing, certain of its obligations, the Company will be required to repurchase Mr. Brunson's shares on such date unless Mr. Brunson waives his right to require the Company to purchase his shares. Any liability is deemed, at this time, not to be material to the Company's Condensed Consolidated Financial Statements. No amounts have been accrued related to potential amounts payable to Mr. Brunson associated with the Stoker restructuring bonus or the requirement to repurchase his stock.

During the nine months ended September 30, 2005, the Company recorded approximately \$1.1 million relating to the resignation of Mr. Brunson. Any options or shares of restricted stock granted to Mr. Brunson vested in full as of the date of such resignation.

A&M is entitled to a fee based on improvement in the Company's financial performance as measured against the Company's 2005 Business Plan, to be paid upon the termination of the engagement. One portion of the fee will be a specified percentage of the sustainable annualized EBITDAR improvement, as defined, and the other portion of the fee will be an amount to be determined by the Board of Directors of the Company in their reasonable judgment for significant and sustainable improvement in working capital investment and management, in each case as measured against the Company's 2005 Business Plan. As of September 30, 2005, no related liability or expense has been recorded relating to financial performance improvements.

### 15. SEGMENT INFORMATION

In accordance with SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," the Company has three reportable segments. The smokeless tobacco segment manufactures smokeless tobacco products which are distributed primarily through wholesale and food distributors in the United States. The make-your-own segment imports and distributes premium cigarette papers and contract manufactures and distributes cigarette tobaccos and related products primarily through wholesale distributors in the United States. The premium cigarette segment distributes contract manufactured cigarettes through

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wholesale distributors in the United States.

The accounting policies of these segments are the same as those of the Company. Segment data includes a charge allocating corporate costs to the Smokeless Tobacco and Make-Your-Own segments based on their respective Net sales. Other includes the assets of the Company not assigned to segments and Eliminations includes the elimination of intercompany accounts between segments. The Company evaluates the performance of its segments and allocates resources to them based on Operating income.

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RECLASSIFICATIONS: Certain prior year amounts have been reclassified to conform to the current year presentation. These changes had no impact on previously reported net income.

FOR THE THREE MONTHS ENDED: SEPTEMBER 30, 2005	SMOKELESS TOBACCO	MAKE YOUR OWN	PREMIUM MANUFACTURED CIGARETTES	OTHER
Net sales	\$ 11,364	\$ 16,233	\$ 54	\$ 1,196
Operating income	2,377	3,833	(1,184)	200
Assets	76,705	286,428	4,482	22,076

September 30, 2004

Net sales	\$ 11,379	\$ 18,059	\$ 42	\$ 1,261
Operating income	4,220	7,923	(1,118)	275
Assets	71,514	285,572	4,100	23,247

FOR THE NINE MONTHS ENDED: SEPTEMBER 30, 2005	SMOKELESS TOBACCO	MAKE YOUR OWN	PREMIUM MANUFACTURED CIGARETTES	OTHER
Net sales	\$ 32,907	\$ 49,770	\$ 385	\$ 3,654
Operating income	2,636	10,128	(3,342)	515
Assets	76,705	286,428	4,482	22,076

SEPTEMBER 30, 2004

Net sales	\$ 35,341	\$ 50,764	\$ 165	\$ 3,783
Operating income	10,259	13,207	(3,624)	85
Assets	71,514	285,572	4,100	23,247

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

The Company competes in three distinct markets: (1) the smokeless tobacco market; (2) the Make-Your-Own ("MYO") cigarette market; and (3) the premium manufactured cigarette market. The smokeless tobacco market includes the loose leaf chewing tobacco sector. The MYO cigarette market is comprised of the MYO premium cigarette papers sector and the MYO cigarette tobaccos and related products sector. The Company's subsidiaries manufacture and market loose leaf

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chewing tobacco, import and distribute MYO premium cigarette papers, contract manufacture and market MYO cigarette tobaccos and related products, and contract manufacture and market premium manufactured cigarettes. To date, the Company's premium manufactured cigarette segment continues in its development phase and net sales of this segment have not been significant.

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### RESULTS OF OPERATIONS

#### COMPARISON OF THREE MONTHS ENDED SEPTEMBER 30, 2005 AND 2004

**Net Sales.** Net sales for the three months ended September 30, 2005 were \$28.8 million, a decrease of \$1.9 million or 6.2% from the corresponding period of the prior year.

Net sales of the smokeless tobacco segment for the three months ended September 30, 2005 were \$11.4 million which were flat compared to the corresponding period of the prior year. Despite a price increase in the Company's premium brands, overall net sales reflected no increase due to a continuing decline in the segment coupled with a product mix shift from premium to value brands.

Net sales of the Company's MYO segment decreased \$1.8 million or 10.1% in comparison to the corresponding period of the prior year. Within the MYO segment, premium cigarette paper sales decreased \$3.4 million or 26.5% from the corresponding period of the prior year due to the Company's continuing efforts to reduce trade inventories. The MYO cigarette tobaccos and related product sales increased \$1.6 million or 29.2% in comparison to the corresponding period of the prior year due in part to a price increase instituted during June 2005.

**Gross Profit.** Gross profit for the three months ended September 30, 2005 totaled \$14.6 million, a decrease of \$2.3 million or 13.7% from the corresponding period of the prior year.

Gross profit of the smokeless tobacco segment increased \$0.3 million or 5.4% from the corresponding period of the prior year. Gross margin for this segment increased to 52.8% of net sales for the current period from 50.0% in the corresponding period of the prior year due to a price increase instituted during June 2005.

Gross profit of the MYO segment for the current period decreased \$2.5 million or 23.1% in comparison to the corresponding period of the prior year. The gross margin of the MYO segment decreased to 50.2% of net sales for the current period in comparison to 58.7% for the corresponding period of the prior year. This decrease in gross margin was due principally to a product mix shift from premium cigarette papers to MYO cigarette tobaccos and related products. Further, gross profit decreased as a result of continuing efforts to reduce trade inventories.

**Selling, General, and Administrative Expenses.** Selling, general, and administrative expenses for the three months ended September 30, 2005 were \$8.6 million, an increase of \$2.9 million or 51.1% in comparison to the corresponding period of the prior year. Of this increase, \$2.9 million resulted from income recognized in the third quarter of 2004 due to the termination of the salaried employee postretirement benefit. In addition, there was an increase in 2005 of \$0.7 million relating to compensation expense, offset by decreased travel of \$0.5 million and other expenses of \$0.2 million.

**Interest Expense and Amortization of Financing Costs.** Interest expense and amortization of financing costs increased \$0.5 million or 6.8% to \$7.8 million for the three months ended September 30, 2005 as compared to the corresponding

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period of the prior year. This increase was primarily due to interest expense related to the \$30.0 million term loan entered into on June 16, 2005.

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Other Expense (Income). Other expense was \$0.9 million for the three months ended September 30, 2005 as compared to other income of \$5.6 million during the corresponding period of the prior year. Other expense of \$0.9 million relates principally to the write-off of equipment no longer used in the manufacturing operations of the business. Other income of \$5.6 million relates principally to non-recurring legal related recoveries received during the third quarter of 2004.

Restructuring Charges. For the three months ended September 30, 2005, total restructuring charges amounted to approximately \$0.9 million, including, but not limited to, severance and separation expenses, A&M fees and other non-recurring expenses. The Company anticipates incurring additional expenses relating to the restructuring during 2005 and 2006.

Income Tax Benefit (Expense). The Company has determined that at December 31, 2004, its ability to realize future benefits of net deferred tax assets does not meet the "more likely than not" criteria in SFAS No. 109, "Accounting for Income Taxes". Therefore, only deferred tax expense related to inventories and tax-deductible goodwill is being recorded in 2005. Tax expense of \$0.6 million was recorded for the nine months ended September 30, 2005 relating to amortization of deferred taxes on inventories and tax-deductible goodwill, and state income taxes, compared to an expense of \$4.4 million for the corresponding period of the prior year. As of September 30, 2005, a valuation allowance continues to be recorded. The effective income tax rate for the three months ended September 30, 2004 was 38.0%.

Net Income (Loss). Due to the factors described above, net loss for the three months ended September 30, 2005 was \$4.0 million compared to net income of \$5.9 million for the corresponding period of the prior year.

### COMPARISON OF NINE MONTHS ENDED SEPTEMBER 30, 2005 AND 2004

Net Sales. Net sales for the nine months ended September 30, 2005 were \$86.7 million, a decrease of \$3.3 million or 3.7% from the corresponding period of the prior year.

Net sales of the smokeless tobacco segment for the current period decreased \$2.4 million or 6.9% from the corresponding period of the prior year. Despite a price increase in the Company's premium brands instituted during June 2005, overall net sales decreased due to a continuing decline in the segment coupled with a product mix shift from premium to value brands.

Net sales of the Company's MYO segment decreased \$1.0 million or 2.0% in comparison to the corresponding period of the prior year. Within the MYO segment, premium cigarette paper sales decreased \$3.2 million or 9.4% from the corresponding period of the prior year due to the Company's continuing efforts to reduce trade inventories. The MYO cigarette tobaccos and related product sales increased \$2.2 million or 13.4% in comparison to the corresponding period of the prior year due in part to a price increase instituted during June 2005.

Gross Profit. Gross profit for the nine months ended September 30, 2005 totaled \$44.3 million, a decrease of \$2.7 million or 5.8% from the corresponding period of the prior year.

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Gross profit of the smokeless tobacco segment decreased \$1.4 million or 8.0% from the corresponding period of the prior year. Gross margin for this segment decreased to 48.4% of net sales for the current period from 49.0% in the corresponding period of the prior year due to several factors, including increased manufacturing costs per case coupled with an increase in case sales of lower margin products.

Gross profit of the MYO segment for the current period decreased \$1.9 million or 6.7% in comparison to the corresponding period of the prior year. The gross margin of the MYO segment decreased to 52.6% of net sales for the current period in comparison to 55.3% for the corresponding period of the prior year. This decrease in gross margin was due principally to a product mix shift from premium cigarette papers to MYO cigarette tobaccos and related products. Further, gross profit decreased as a result of continuing efforts to reduce trade inventories.

**Selling, General, and Administrative Expenses.** Selling, general, and administrative expenses for the nine months ended September 30, 2005 were \$29.4 million, an increase of \$2.4 million or 8.7% in comparison to the corresponding period of the prior year. Of this increase, \$2.9 million resulted from income recognized in the third quarter of 2004 due to the termination of the salaried employee postretirement benefit. In addition, there was an increase in 2005 of \$1.7 million relating to compensation expense, offset by \$2.1 million employee incentive payments made in February 2004 and other expense of \$0.1 million.

**Interest Expense and Amortization of Financing Costs.** Interest expense and amortization of financing costs decreased \$1.2 million or 4.7% to \$23.1 million for the nine months ended September 30, 2005 as compared to the corresponding period of the prior year. This decrease related principally to the write off of old deferred financing costs of approximately \$1.6 million during the first nine months of 2004, relating to the recapitalization and reorganization consummated in 2004, partially offset by the write off of deferred financing costs of approximately \$0.4 million relating to the Senior Revolving Credit Facility which was refinanced during June 2005.

**Other Income (Expense).** Other expense was \$2.5 million for the nine months ended September 30, 2005 as compared to other income of \$5.0 million during the corresponding period of the prior year. Other expense of \$2.5 million relates primarily to the write-off of equipment no longer used in the manufacturing operations of the business and expenses incurred relating to counterfeiting during 2005. Other income of \$5.0 million relates principally to non-recurring legal related recoveries received during the third quarter of 2004.

**Restructuring Charges.** For the nine months ended September 30, 2005, total restructuring charges amounted to approximately \$4.9 million, including, but not limited to, severance and separation expenses, A&M fees and other non-recurring expenses. The Company anticipates incurring additional expenses relating to the restructuring during 2005 and 2006.

**Income Tax Benefit (Expense).** The Company has determined that at December 31, 2004, its ability to realize future benefits of net deferred tax assets does not meet the "more likely than not" criteria in SFAS No. 109, "Accounting for Income Taxes". Therefore, only deferred tax expense related to inventories and tax-deductible goodwill is being recorded in 2005. Tax expense of \$0.6 million was recorded for the nine months ended September 30, 2005 relating to amortization of deferred taxes on inventories and tax-deductible goodwill, and state income taxes, compared to an expense of \$2.2 million for the corresponding period of the prior year. As of September 30, 2005, a valuation allowance continues to be recorded. The effective income tax rate for the nine months ended September 30, 2004 was 38.0%.

**Net Loss.** Due to the factors described above, net loss for the nine months ended

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September 30, 2005 was \$16.2 million compared to net income of \$0.4 million for the corresponding period of the prior year.

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### LIQUIDITY AND CAPITAL RESOURCES

At September 30, 2005, working capital was \$31.8 million compared to \$16.8 million at December 31, 2004, as restated. This increase was the result of a decrease in the revolving credit facility of \$14.5 million, a higher cash balance of \$2.2 million, a decrease in accounts payable of \$1.8 million, a decrease in accrued liabilities of \$2.5 million, and a decrease in deferred taxes of \$0.7 million offset by decreased inventory of \$4.5 million, a decrease in accounts receivable of \$0.4 million and decreased other current assets of \$1.8 million.

For the nine months ended September 30, 2005, net cash used in operating activities was \$6.8 million compared with \$10.9 million in the corresponding period of the prior year. This change was due primarily to reductions in inventory and Other current assets, offset by the net loss.

For the nine months ended September 30, 2005, net cash used in investing activities was \$4.7 (including \$1.2 million relating to deposits recorded in Other current assets in 2004) million compared with \$1.3 million in the corresponding period of the prior year. This change was due to an increase in capital expenditures. The Company believes that its net additions to property, plant and equipment relating to the Stoker integration, purchasing of certain manufacturing equipment and the continuing investment in data and related systems for 2005 will be approximately \$5.0 million.

For the nine months ended September 30, 2005, net cash provided by financing activities was \$13.7 million compared with \$21.2 million in the corresponding period of the prior year. This change was due primarily to the February 2004 refinancing and the June 2005 refinancing under the Financing Agreement.

The Company expects to be able to fund its seasonal working capital requirements through its operating cash flows and, if needed, borrowings under the Financing Agreement. As of September 30, 2005, the Company had not borrowed pursuant to its \$55.0 million revolver under the Financing Agreement.

On June 16, 2005, NATC refinanced its Old Credit Agreement by entering into the Financing Agreement. See Note 8 to the Condensed Consolidated Financial Statements included herein for a description of the Financing Agreement, which description is incorporated herein by reference. The Financing Agreement consists of a \$30.0 million term loan facility and a \$55.0 million revolving credit facility, and includes a letter of credit sublimit of \$10.0 million (collectively, the "Credit Facility"). As of September 30, 2005, NATC had not borrowed any monies under the revolving credit facility. The Credit Facility will mature on June 30, 2010, and does not provide for any amortization of the term loan prior to maturity. NATC will use the revolving credit facility for working capital requirements and other general corporate purposes, including the purchase of Company Notes.

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On October 6, 2005, NATC purchased Company Notes with an accreted book value of approximately \$22.1 million (face value at maturity of approximately \$29.5 million) for approximately \$6.3 million in cash. The Company or NATC may, from time to time, continue to acquire and/or retire all or a portion of the Company Notes and/or New Senior Notes through cash purchases and/or exchanges for other

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securities in open market purchases, privately negotiated transactions or otherwise.

The Company is dependent on NATC's cash flows to service its debt. The amount of cash interest to be paid by the Company to third parties during the next five years is as follows: \$0 in each of 2005, 2006, 2007 and March 1, 2008; \$4,137 payable on September 1, 2008 and \$4,137 payable on each of March 1 and September 1 thereafter, until maturity.

### CONTRACTUAL OBLIGATIONS

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Certain contractual obligations are summarized in our Annual Report on Form 10-K, as amended, for the year ended December 31, 2004 under the heading "Contractual Obligations" in "Management's Discussion and Analysis of Financial Condition and Results of Operations." As of September 30, 2005, with the exceptions of the term loan under the Financing Agreement and the payoff of the Senior Revolving Credit Facility in connection with the June 2005 refinancing (see Note 8 to the Condensed Consolidated Financial Statements contained herein) and the forward contracts entered into as more fully described in Item 3, Quantitative and Qualitative Disclosures about Market Risk, there have been no material changes outside the ordinary course of our business in such contractual obligations from December 31, 2004.

### FORWARD-LOOKING STATEMENTS

The Company cautions the reader that certain statements in the Management's Discussion and Analysis of Financial Condition and Results of Operations section as well as elsewhere in this Form 10-Q are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are not guarantees of future performance. They involve risks, uncertainties and other important factors, including the risks discussed below. The Company's actual future results, performance or achievement of results may differ materially from any such results, performance or achievement implied by these statements. Among the factors that could affect the Company's actual results and could cause results to differ from those anticipated in the forward-looking statements contained herein is the Company's ability to comply with certain Financing Agreement financial covenants, its ability to implement its business strategy successfully, which may be dependent on business, financial, and other factors beyond the Company's control, including, among others, federal, state and/or local regulations and taxes, competitive pressures, prevailing changes in consumer preferences, consumer acceptance of new product introductions and other marketing initiatives, market acceptance of the Company's current distribution programs, access to sufficient quantities of raw material or inventory to meet any sudden increase in demand, disruption to historical wholesale ordering patterns, product liability litigation and any disruption in access to capital necessary to achieve the Company's business strategy.

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The Company cautions the reader not to put undue reliance on any forward-looking statements. In addition, the Company does not have any intention or obligation to update the forward-looking statements in this document. The Company claims the protection of the safe harbor for forward-looking statements contained in Section 21E of the Securities Exchange Act of 1934.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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Except as described below, there have not been any significant changes with respect to quantitative and qualitative disclosures about market risk from what was previously disclosed in the Company's Annual Report on Form 10-K, as amended, for the year ended December 31, 2004.

The Company purchases inventory from Bollore, payable in Euros, on terms of net 45 days. Accordingly, exposure exists to potentially adverse movement in foreign currency rates (Euros). In addition, Bollore provides contractual relief against significant currency fluctuations in its agreement with the Company. While the Company does not use derivative financial instruments for speculative trading purposes, it hedges its foreign currency exposure through the purchase of forward contracts.

As of September 30, 2005, the Company has forward contracts outstanding of approximately 6.1 million Euros. A one percent fluctuation in the Euro vs. U.S. Dollar exchange rate would result in a gain or loss on Euro denominated accounts payable of approximately \$0.1 million with a corresponding gain or loss to the forward contracts.

### ITEM 4. CONTROLS AND PROCEDURES

#### DISCLOSURE CONTROLS AND PROCEDURES

The Company's management, with the participation of the Company's principal executive and principal financial officers, has evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of September 30, 2005, and has concluded that the Company's disclosure controls and procedures were not effective as of September 30, 2005 because of the material weakness in the Company's internal control over financial reporting discussed below under "Internal Control Over Financial Reporting."

#### INTERNAL CONTROL OVER FINANCIAL REPORTING

The Company has determined that, as of December 31, 2004, it had a deficiency in internal controls over the valuation of deferred income tax assets. Specifically, the Company did not have adequate controls over the accounting for and the review and approval of income tax related financial statement accounts requiring a significant degree of technical knowledge related to deferred tax assets and liabilities. As a result of the ineffective review, an error in the deferred tax valuation allowance was not detected prior to the issuance of the 2004 consolidated financial statements. This control deficiency resulted in the restatement of the Company's 2004 annual and first quarter 2005 consolidated financial statements. In addition this control deficiency could result in a misstatement to deferred tax valuation allowance that could result in a material misstatement to the annual or interim financial statements. Accordingly, management determined that this control deficiency constitutes a material weakness. A material weakness is a control deficiency, or combination of control deficiencies, that results in a more than remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

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#### REMEDIATION PLAN

During the fiscal quarter ended September 30, 2005, the Company has taken remedial steps to eliminate this material weakness, including engaging the



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services of an independent public accounting firm with appropriate levels of income tax accounting knowledge and expertise to assist in the review of complex tax matters. As of September 30, 2005, these remediation efforts, and the Company's evaluation of its internal controls over the valuation of deferred income tax assets, are continuing.

### CHANGES IN INTERNAL CONTROL

Other than as discussed in the preceding paragraph, there has been no change in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15-d-15(f) under the Exchange Act) that occurred during the Company's fiscal quarter ended September 30, 2005, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

## PART II OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

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Reference is made to the information contained in Note 14 to the Condensed Consolidated Financial Statements included herein, which information is incorporated herein by reference.

### ITEM 6. EXHIBITS

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- 31.1 Certification by the Chief Executive Officer pursuant to rule 13-14(a) or 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification by the Chief Financial Officer pursuant to rule 13-14(a) or 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to section 302 of the Sarbanes-Oxley Act of 2002.

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### SIGNATURES

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

NORTH ATLANTIC HOLDING COMPANY, INC.

Date: November 14, 2005

/s/ Douglas P. Rosefsky

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Douglas P. Rosefsky  
Chief Executive Officer

/s/ Brian C. Harriss

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Brian C. Harriss  
Chief Financial Officer

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EXHIBIT INDEX

No. ---	Description -----
31.1	Certification by the Chief Executive Officer pursuant to rule 13-14(a) or 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification by the Chief Financial Officer pursuant to rule 13-14(a) or 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to section 302 of the Sarbanes-Oxley Act of 2002.

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