

LENOX GROUP INC  
Form 10-Q  
August 07, 2008

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

## **FORM 10-Q**

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

For the quarterly period ended: **June 28, 2008**

Commission File Number: 1-11908

## **Lenox Group Inc.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of incorporation or organization)

**13-3684956**

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

**One Village Place, 6436 City West Parkway, Eden Prairie, MN 55344**

(Address of principal executive offices)

(Zip Code)

**(952) 944-5600**

(Registrant's telephone number, including area code)

**Not Applicable**

(Former name, former address, and former fiscal year, if changed since last report)

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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 a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☐ Accelerated filer ☒ Smaller reporting company ☒

Non-accelerated filer ☐ (Do not check if a smaller reporting company.)

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

As of August 4, 2008, 14,429,998 shares of the registrant's common stock, par value \$.01 per share, were outstanding.

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**PART I - FINANCIAL INFORMATION**

**Item 1. Financial Statements**

## LENOX GROUP INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(In thousands)

## ASSETS

|                             | June 28,<br>2008 | December 29,<br>2007 | June 30,<br>2007 |
|-----------------------------|------------------|----------------------|------------------|
| Current Assets:             |                  |                      |                  |
| Cash and cash equivalents   | \$ 385           | \$ 3,081             | \$ 254           |
| Accounts receivable, net    | 53,913           | 43,273               | 62,407           |
| Inventories                 | 109,928          | 84,415               | 109,585          |
| Assets held for sale        |                  |                      | 6,604            |
| Deferred taxes              | 1,259            | 17,347               | 16,328           |
| Income tax receivable       | 9,608            | 10,114               | 16,052           |
| Other current assets        | 6,976            | 8,405                | 7,251            |
| Total current assets        | 182,069          | 166,635              | 218,481          |
| Property and equipment, net | 38,163           | 41,987               | 42,979           |
| Assets held for sale        |                  |                      | 1,494            |
| Trademarks, net             | 105,715          | 119,941              | 119,092          |
| Other intangibles, net      | 11,003           | 11,984               | 13,017           |
| Marketable securities       | 20               | 71                   | 340              |
| Other assets                | 10,304           | 11,488               | 12,392           |
| Total Assets                | \$ 347,274       | \$ 352,106           | \$ 407,795       |

## LIABILITIES AND STOCKHOLDERS' EQUITY

|                                           | June 28,<br>2008 | December 29,<br>2007 | June 30,<br>2007 |
|-------------------------------------------|------------------|----------------------|------------------|
| Current liabilities:                      |                  |                      |                  |
| Current portion of long-term debt         | \$ 1,250         | \$ 1,250             | \$ 1,250         |
| Borrowings on revolving credit facility   | 69,927           | 8,938                | 68,249           |
| Accounts payable                          | 31,100           | 31,836               | 29,415           |
| Accrued compensation and benefits payable | 7,356            | 8,727                | 6,683            |
| Severance and restructuring reserves      | 1,000            | 2,756                | 5,425            |
| Other current liabilities                 | 6,354            | 8,826                | 7,777            |
| Total current liabilities                 | 116,987          | 62,333               | 118,799          |
| Deferred compensation obligation          |                  | 54                   | 328              |
| Pension obligations                       | 12,139           | 15,788               | 26,214           |
| Postretirement obligations                | 1,356            | 1,585                | 15,373           |
| Deferred taxes                            | 31,440           | 25,531               | 18,484           |
| Long-term debt                            | 98,000           | 98,500               | 98,750           |
| Deferred gain on sale-leaseback           | 3,433            | 3,570                | 3,708            |
| Other noncurrent liabilities              | 8,802            | 8,603                | 10,050           |
| Total stockholders' equity                | 75,117           | 136,142              | 116,089          |
|                                           | \$ 347,274       | \$ 352,106           | \$ 407,795       |

See notes to condensed consolidated financial statements.

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**LENOX GROUP INC. AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)**

(In thousands, except per share amounts)

|                                      | 13 Weeks Ended<br>June 28, 2008 | 13 Weeks Ended<br>June 30, 2007 |
|--------------------------------------|---------------------------------|---------------------------------|
| NET SALES                            | \$ 76,209                       | \$ 92,971                       |
| COST OF SALES                        | 37,355                          | 49,658                          |
| GROSS PROFIT                         | 38,854                          | 43,313                          |
| OPERATING EXPENSES                   |                                 |                                 |
| Selling, general and administrative  | 42,074                          | 49,860                          |
| Trademark impairment                 | 14,226                          |                                 |
| Asset impairment                     | 2,588                           |                                 |
| Restructuring charges                | 429                             | 2,077                           |
| OPERATING LOSS                       | (20,463 )                       | (8,624 )                        |
| OTHER EXPENSE (INCOME)               |                                 |                                 |
| Interest expense                     | 3,446                           | 4,072                           |
| Loss on refinancing of debt          |                                 | 5,940                           |
| Other, net                           | (84 )                           | (93 )                           |
| LOSS BEFORE INCOME TAXES             | (23,825 )                       | (18,543 )                       |
| INCOME TAX EXPENSE (BENEFIT)         | 26,848                          | (7,232 )                        |
| NET LOSS                             | \$ (50,673 )                    | \$ (11,311 )                    |
| NET LOSS PER SHARE BASIC             | (3.63 )                         | (0.82 )                         |
| NET LOSS PER SHARE ASSUMING DILUTION | (3.63 )                         | (0.82 )                         |
| WEIGHTED AVERAGE SHARES OUTSTANDING  |                                 |                                 |
| BASIC                                | 13,941                          | 13,812                          |
| ASSUMING DILUTION                    | 13,941                          | 13,812                          |

See notes to condensed consolidated financial statements.

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**LENOX GROUP INC. AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)**

(In thousands, except per share amounts)

|                                      | 26 Weeks<br>Ended<br>June 28, 2008 | 26 Weeks<br>Ended<br>June 30, 2007 |
|--------------------------------------|------------------------------------|------------------------------------|
| NET SALES                            | \$ 147,607                         | \$ 179,365                         |
| COST OF SALES                        | 71,949                             | 99,438                             |
| GROSS PROFIT                         | 75,658                             | 79,927                             |
| OPERATING EXPENSES                   |                                    |                                    |
| Selling, general and administrative  | 88,192                             | 103,107                            |
| Trademark impairment                 | 14,226                             |                                    |
| Asset impairment loss                | 2,588                              |                                    |
| Restructuring charges                | 1,518                              | 6,868                              |
| OPERATING LOSS                       | (30,866 )                          | (30,048 )                          |
| OTHER EXPENSE (INCOME)               |                                    |                                    |
| Interest expense                     | 6,733                              | 6,900                              |
| Loss on refinancing of debt          |                                    | 5,940                              |
| Other, net                           | 19                                 | (105 )                             |
| LOSS BEFORE INCOME TAXES             | (37,618 )                          | (42,783 )                          |
| INCOME TAX EXPENSE (BENEFIT)         | 22,106                             | (18,477 )                          |
| NET LOSS                             | \$(59,724 )                        | \$(24,306 )                        |
| NET LOSS PER SHARE BASIC             | (4.29 )                            | (1.76 )                            |
| NET LOSS PER SHARE ASSUMING DILUTION | (4.29 )                            | (1.76 )                            |
| WEIGHTED AVERAGE SHARES OUTSTANDING  |                                    |                                    |
| BASIC                                | 13,909                             | 13,798                             |
| ASSUMING DILUTION                    | 13,909                             | 13,798                             |

See notes to condensed consolidated financial statements.

**LENOX GROUP INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)****(In thousands)**

|                                                          | 26 Weeks<br>Ended<br>June 28, 2008 | 26 Weeks<br>Ended<br>June 30, 2007 |
|----------------------------------------------------------|------------------------------------|------------------------------------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>             |                                    |                                    |
| Net cash used in operating activities                    | \$(58,835 )                        | \$(61,215 )                        |
| Net cash used in operating activities                    | (58,835 )                          | (61,215 )                          |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>             |                                    |                                    |
| Purchases of property and equipment                      | (4,643 )                           | (1,551 )                           |
| Proceeds from sale of assets                             | 314                                | 407                                |
| Acquisitions                                             |                                    | (212 )                             |
| Net cash used by investing activities                    | (4,329 )                           | (1,356 )                           |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>             |                                    |                                    |
| Payments of debt amendment and refinancing costs         |                                    | (9,685 )                           |
| Excess tax benefits from stock-based compensation        |                                    | (7 )                               |
| Borrowings on revolving credit facility                  | 60,989                             | 20,739                             |
| Purchases of treasury stock                              | (12 )                              | (30 )                              |
| Principal payments on capital leases                     | (10 )                              | (11 )                              |
| Payments on long-term debt                               | (499 )                             | 50,944                             |
| Net cash provided by financing activities                | 60,468                             | 61,950                             |
| <b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>         | <b>(2,696 )</b>                    | <b>(621 )</b>                      |
| <b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>  | <b>3,081</b>                       | <b>875</b>                         |
| <b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>        | <b>\$385</b>                       | <b>\$254</b>                       |
| <b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION</b> |                                    |                                    |
| Depreciation expense                                     | \$4,856                            | \$6,397                            |
| Intangible amortization expense                          | 982                                | 1,118                              |
| Accrued capital expenditure purchases                    | 324                                |                                    |
| <b>Cash paid (received) for:</b>                         |                                    |                                    |
| Interest                                                 | 6,042                              | 4,130                              |
| Income taxes                                             | (440 )                             | (94 )                              |

See notes to condensed consolidated financial statements

## LENOX GROUP INC. AND SUBSIDIARIES

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(In thousands, except per share amounts)

#### 1. Basis of Presentation

The Condensed Consolidated Balance Sheets as of June 28, 2008 and June 30, 2007, the Condensed Consolidated Statements of Operations for the 13 weeks and 26 weeks ended June 28, 2008 and June 30, 2007 and the Condensed Consolidated Statements of Cash Flows for the 26 weeks ended June 28, 2008 and June 30, 2007 are unaudited. The Consolidated Balance Sheet as of December 29, 2007 was derived from audited consolidated financial statements, but does not include all disclosures required by Generally Accepted Accounting Principles in the United States of America.

In the opinion of management, all adjustments necessary for a fair presentation of the consolidated financial statements are included. Adjustments consist only of normal recurring items, except for any discussed in the notes below. Interim results are not necessarily indicative of results for a full year. The condensed consolidated financial statements and notes are presented in accordance with instructions for Form 10-Q, and therefore, do not contain certain information included in our consolidated annual financial statements and notes. The condensed consolidated financial statements and notes appearing in this report should be read in conjunction with the consolidated audited financial statements and related notes included in the Annual Report on Form 10-K for the year ended December 29, 2007 ( 2007 Form 10-K ) filed by Lenox Group Inc. (the Company ) with the Securities and Exchange Commission ( SEC ).

Due in part to the negative impact of current economic and retail market conditions, the Company does not expect to remain in compliance with its financial covenants at the end of the third quarter of 2008. The Company's ability to continue with its current capital and operating structure and to fund operations would be contingent upon the Company's ability to negotiate a waiver with its lenders and/or restructure its outstanding indebtedness. There is currently no assurance that such a waiver can be obtained or that such a restructuring can occur. However, the Company is currently pursuing certain actions to strengthen its balance sheet and reduce indebtedness, and has commenced discussions with its term loan and credit facility lenders to restructure its outstanding indebtedness.

#### 2. New Accounting Standards

##### *Recently Adopted Accounting Standards*

In September 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 157, *Fair Value Measurements*. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 became effective for our financial assets and liabilities on January 1, 2008. The FASB has deferred the implementation of the provisions of SFAS No. 157 relating to certain nonfinancial assets and liabilities until January 1, 2009. SFAS No. 157 did not materially affect how we determine fair value.

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In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS No. 159 permits companies to measure many financial instruments and certain other items at fair value. SFAS No. 159 became effective for the Company on January 1, 2008. The Company has not elected the fair value option for any of its existing financial instruments on the effective date and has not determined whether or not it will elect this option for any eligible financial instruments it acquires in the future.

### *Recently Issued Accounting Standards*

In June 2008, the FASB issued FASB Staff Position ( FSP ) No. Emerging Issues Task Force ( EITF ) 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* ( FSP EITF 03-6-1 ). FSP EITF 03-6-1 is effective for the Company in the first quarter of fiscal 2009. The Company does not expect that the adoption of FSP EITF 03-6-1 will have a material impact on the Company's consolidated and combined financial statements.

In May 2008, the FASB issued Statement of Financial Accounting Standards No. 162 ( SFAS 162 *The Hierarchy of Generally Accepted Accounting Principles* ). SFAS No. 162 is effective for the Company sixty days following the Securities and Exchange Commission ( SEC ) approval of the Public Company Accounting Oversight Board amendments to AU Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, which is expected to occur during the fourth quarter of fiscal 2008. The Company does not expect that adoption of the standard will impact its consolidated and combined financial statements.

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In March 2008, the FASB issued Statement of Financial Accounting Standards No 161 ( SFAS 161 *Disclosures about Derivative Instruments and Hedging Activities* ). SFAS 161 requires companies with derivative instruments to disclose information that should enable financial statement users to understand how and why a company uses derivative instruments, how derivative instruments and related hedged items are accounted for under FASB Statement No. 133 *Accounting for Derivative Instruments and Hedging Activities* and how derivative instruments and related hedged items affect a company's financial position, financial performance and cash flows. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. We are currently evaluating the impact, if any, that SFAS 161 will have on our consolidated financial statements.

In December 2007, the FASB issued Statement No. 141(R), *Business Combinations* ( SFAS 141R ). SFAS 141R established the principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. SFAS 141R also establishes rules for recognition and measurement of the goodwill acquired in the business combination and the gains from bargain purchases. SFAS 141R is effective for the Company in the first quarter of fiscal 2009. The Company is currently assessing the impact that SFAS 141R will have on its results of operations, financial position and cash flows.

### **3. Stock-Based Compensation**

The Company recognizes compensation for share-based awards over the requisite service period. This is the period of time between the grant date and the awards stated vesting term. The Company recognizes time-vesting compensation expense to operations over the applicable service periods and performance-vesting compensation expense over the applicable service period when it is probable the performance goals will be achieved.

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Total share-based compensation expense (benefit) was \$117 and \$260 for the 13 weeks ended June 28, 2008, and June 30, 2007, respectively, and \$366 and \$(661) for the 26 weeks ended June 28, 2008 and June 30, 2007, respectively. During the 26 weeks ended June 30, 2007, forfeiture of restricted stock with performance conditions that were not met resulted in a reduction of the associated expense.

The Company granted 6,000 restricted shares of common stock to employees during the 13 weeks ended June 28, 2008 and 261,000 restricted shares of common stock to executive officers, directors and employees during the 26 weeks ended June 28, 2008. Of these shares, 247,000 were performance-vesting and 14,000 shares were time-vesting. The weighted average price per share was \$1.52 and \$1.75 respectively, during the 13 week and 26 week periods ended June 28, 2008. Shares were priced at the market price of the Company's common stock on the date of the grant. During the 13 weeks ended June 30, 2007, 15,500 restricted shares of common stock were issued to directors. These shares were time-based and were valued at \$7.11 per share, the market price on the date of the grant. No restricted shares were issued during the 13 weeks ended March 31, 2007. Total compensation expense for non-vested restricted stock during the 13 weeks ended June 28, 2008, and June 30, 2007, was \$157 and \$107, respectively. For the 26 weeks ended June 28, 2008 and June 30, 2007, compensation expense (benefit) for non-vested restricted stock was \$267 and \$(810), respectively.

During the 13 weeks ended June 28, 2008, no stock option awards were granted. During the 26 weeks ended June 28, 2008, 28,000 stock option awards were granted to directors. These stock option awards vest one year from the date of the grant and have an exercise price equal to the market price of the Company's common stock on the date of the grant. During the 13 weeks ended June 30, 2007, 31,000 option awards were granted to directors. These option awards vested one year from the date of the grant and had an exercise price equal to the market price of the Company's common stock on the date of the grant. These option awards were not exercised. No option awards were granted during the 13 weeks ended March 31, 2007. Total compensation expense/(benefit) for stock option awards for the 13 weeks ended June 28, 2008 and June 30, 2007 was \$(91) and \$56, respectively and \$(38) and \$52 for the six months ended June 28, 2008 and June 30, 2007. During the 26 weeks ended June 28, 2008, forfeiture of stock options resulted in a reduction of the associated expense.

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The Company estimates the fair value of each stock option using the Black-Scholes option pricing model. Assumptions used were:

|                              | 26 weeks<br>ended<br>June 28,<br>2008 | 26 weeks<br>ended<br>June 30,<br>2007 |
|------------------------------|---------------------------------------|---------------------------------------|
| Risk-free interest rate      | 2.49%                                 | 4.6%                                  |
| Expected dividend<br>yield   | 0.0%                                  | 0.0%                                  |
| Expected stock<br>volatility | 51.0%                                 | 39.0%                                 |
| Expected life (in<br>years)  | 6.0                                   | 5.0                                   |

The weighted average fair value of options granted during the 26 weeks ended June 28, 2008 and June 30, 2007 was \$.90 and \$2.95, respectively.

The Company recognized \$51 and \$137 of share-based expense during the 13 week and 26 week periods ended June 28, 2008 related to director's compensation. The Company recognized \$97 of share-based expense during the 13 week period ended June 30, 2007 related to

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director's compensation. There was no share-based expense for director's compensation for the 13 week period ended March 30, 2007.

### 4. Loss per Common Share

Net loss per common share is calculated by dividing net loss by the weighted average number of shares outstanding during the period. Net loss per common share assuming dilution reflects per share amounts that would have resulted had the Company's dilutive outstanding stock options been converted to common stock. Restricted stock is considered outstanding on the date the stock becomes vested when computing net income (loss) per common share - basic. Restricted stock, to the extent it is probable that the stock will become vested, is considered outstanding on the grant date when computing net income (loss) per common share - assuming dilution. Stock options and unvested restricted shares totaling 468 and 116 for the 13 weeks ended June 28, 2008 and June 30, 2007 respectively and 394 and 164 for the 26 weeks ended June 28, 2008 and June 30, 2007 respectively were considered anti-dilutive and excluded from the computation of common equivalent shares because the Company reported a net loss.

### 5. Severance and Restructuring Costs

During the first quarter of 2007, the Company engaged Carl Marks Advisory Group LLC to identify and implement business improvements and operational changes. Restructuring activities initiated during 2007 included the announcement of the planned closing of the Company's distribution center located in Rogers, MN in late 2007 (with distribution activities to be transferred to the Company's distribution center located in Hagerstown, MD), the sale of the Company's sterling silver product line and closure of the Company's sterling silver manufacturing facility located in Pomona, NJ and changes in and consolidation of our management and operations structure (described as general restructuring below). The Company incurred \$9,540 of severance and restructuring costs related to these activities in 2007. These costs were included in the restructuring charges in the Condensed Consolidated Statement of Operations for 2007. For the 26 weeks ended June 28, 2008, the Company incurred an additional \$1,518 of severance and restructuring costs related to these activities.

The table below shows a reconciliation of the severance and restructuring reserve activity through the second quarter of 2008:

|                            | Plant and Distribution<br>Center Closings |          | General Restructuring |       | Total Reserves |
|----------------------------|-------------------------------------------|----------|-----------------------|-------|----------------|
|                            | Severance                                 | Other    | Severance             | Other |                |
| Balance, December 29, 2007 | \$ 704                                    | \$ 267   | \$ 1,745              | \$ 40 | \$ 2,756       |
| Costs incurred             | 37                                        | 896      | 585                   |       | 1,518          |
| Payments and other         | (557 )                                    | (1,163 ) | (1,554 )              |       | (3,274 )       |
| Balance, June 28, 2008     | \$ 184                                    | \$       | \$ 776                | \$ 40 | \$ 1,000       |

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The total estimated costs expected to be incurred related to the plant and distribution center closings and the general restructuring that were initiated during 2007, including costs incurred during the 13 and 26 weeks ended June 28, 2008, were as follows:

|                                        | Total costs<br>expected | Costs Incurred                  |                                 | Cumulative through |
|----------------------------------------|-------------------------|---------------------------------|---------------------------------|--------------------|
|                                        |                         | 13 weeks ended<br>June 28, 2008 | 26 weeks ended<br>June 28, 2008 | June 28, 2008      |
| Plant and Distribution Center Closings | \$ 3,393                | (\$135 )                        | \$ 934                          | \$ 3,393           |

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|                       |           |        |          |           |
|-----------------------|-----------|--------|----------|-----------|
| General Restructuring | 7,664     | 564    | 584      | 7,664     |
|                       | \$ 11,057 | \$ 429 | \$ 1,518 | \$ 11,057 |

The additional costs incurred during the 13 and 26 weeks ended June 28, 2008 with respect to Plant and Distribution Center closings were principally severance and exit costs associated with the closure of the Company's Rogers Distribution Center. The additional general restructuring costs related primarily to severance costs related to retail store closings and other cost reduction initiatives.

These costs are allocable to reportable segments as follows:

|           | Total costs | Costs Incurred<br>13 weeks ended | 26 weeks ended | Cumulative through |
|-----------|-------------|----------------------------------|----------------|--------------------|
|           | expected    | June 28, 2008                    | June 28, 2008  | June 28, 2008      |
| Wholesale | \$ 619      | \$ 77                            | \$ 77          | \$ 619             |
| Retail    | 1,223       | 10                               | 25             | 1,223              |
| Direct    | 235         | 17                               | 22             | 235                |
| Corporate | 8,980       | 325                              | 1,394          | 8,980              |
|           | \$ 11,057   | \$ 429                           | \$ 1,518       | \$ 11,057          |

### 6. Concentrations

At June 28, 2008, one customer accounted for approximately 16% of the Company's total accounts receivable. For the 13 and 26 weeks ended June 28, 2008, this same customer accounted for approximately 18% and 16%, respectively, of the Company's total net sales.

### 7. Inventories

Inventories were comprised of:

|                   | June 28,<br>2008 | December 29,<br>2007 | June 30,<br>2007 |
|-------------------|------------------|----------------------|------------------|
| Raw materials     | \$ 3,190         | \$ 2,655             | \$ 3,080         |
| Work-in-process   | 2,948            | 3,925                | 4,407            |
| Finished goods    | 103,790          | 77,835               | 102,098          |
| Total inventories | \$ 109,928       | \$ 84,415            | \$ 109,585       |

The Company terminated its precious metals consignment arrangement in the second quarter of 2007, at which time the Company purchased the remaining outstanding silver inventory balance at a cost of \$4,617. The Company sold its sterling silver product line and its entire related sterling silver inventory during the third quarter of 2007.

**8. Comprehensive Loss**

Comprehensive loss and its components, net of tax, were as follows:

|                                                               | 13 weeks ended   |                  | 26 weeks ended   |                  |
|---------------------------------------------------------------|------------------|------------------|------------------|------------------|
|                                                               | June 28,<br>2008 | June 30,<br>2007 | June 28,<br>2008 | June 30,<br>2007 |
| Net loss                                                      | \$(50,673 )      | \$(11,311 )      | \$(59,724 )      | \$(24,306 )      |
| Changes in cumulative foreign currency translation adjustment | 3                |                  | 5                | (14 )            |
| Adjustment to pension and postretirement plan liabilities     | (1,156 )         | (319 )           | (1,658 )         | (638 )           |
| Comprehensive loss                                            | \$(51,826 )      | \$(11,630 )      | \$(61,377 )      | \$(24,958 )      |

**9. Trademarks and Other Intangible Assets**

Intangible assets, other than goodwill, are comprised of the following:

|                                          | June 28, 2008      |                             |                   | December 29, 2007  |                             |                   | June 30, 2007      |                             |                   |
|------------------------------------------|--------------------|-----------------------------|-------------------|--------------------|-----------------------------|-------------------|--------------------|-----------------------------|-------------------|
|                                          | Gross              |                             |                   | Gross              |                             |                   | Gross              |                             |                   |
|                                          | Carrying<br>amount | Accumulated<br>amortization | Net               | Carrying<br>amount | Accumulated<br>amortization | Net               | Carrying<br>amount | Accumulated<br>amortization | Net               |
| <b>Finite-life intangible assets</b>     |                    |                             |                   |                    |                             |                   |                    |                             |                   |
| Customer relationships                   | \$ 15,300          | \$ (4,680 )                 | \$ 10,620         | \$ 15,300          | \$ (3,854 )                 | \$ 11,446         | \$ 15,300          | \$ (3,028 )                 | \$ 12,272         |
| Favorable lease interests                | 2,542              | (2,324 )                    | 218               | 2,542              | (2,238 )                    | 304               | 2,542              | (2,102 )                    | 440               |
| Non-compete agreements                   | 2,705              | (2,540 )                    | 165               | 2,705              | (2,471 )                    | 234               | 2,705              | (2,400 )                    | 305               |
|                                          | 20,547             | (9,544 )                    | 11,003            | 20,547             | (8,563 )                    | 11,984            | 20,547             | (7,530 )                    | 13,017            |
| <b>Indefinite-life intangible assets</b> |                    |                             |                   |                    |                             |                   |                    |                             |                   |
| Trademarks                               | 109,854            | (4,139 )                    | 105,715           | 124,080            | (4,139 )                    | 119,941           | 123,231            | (4,139 )                    | 119,092           |
| <b>Total Intangibles</b>                 | <b>\$ 130,401</b>  | <b>\$ (13,683 )</b>         | <b>\$ 116,718</b> | <b>\$ 144,627</b>  | <b>\$ (12,702 )</b>         | <b>\$ 131,925</b> | <b>\$ 143,778</b>  | <b>\$ (11,669 )</b>         | <b>\$ 132,109</b> |

The Company's intangible assets are tested for impairment annually unless events or circumstances would require an immediate review. During the second quarter of 2008 the Company's stock price dropped significantly. Due to the current economic conditions that have resulted in an extremely weak retail environment, the Company re-forecast its full year 2008 revenue and earnings projections which was completed in the second quarter. Based on these events the Company performed a fair-value based impairment test as of June 28, 2008. In determining the fair value of its trademarks, the Company applies the income approach, using the relief from royalty method.

The Company markets its products under the Lenox®, Department 56®, Dansk® and Gorham® trademarks. Upon completion of the impairment test, the Company concluded that the fair value of the Department 56 and Gorham trademarks was lower than the carrying value. Therefore, the Company recorded, in the Corporate segment, an impairment charge of \$14,226 in the second quarter of 2008. This charge was comprised of \$13,049 and \$1,177 related to the Department 56 and Gorham trademarks, respectively. The remaining carrying values of the Department 56 and Gorham trademarks as of June 28, 2008 were \$3072, and \$2,961 respectively.

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During 2007, finalization of the purchase price allocation related to the Willitts acquisition resulted in an increase of \$127 to the indefinite-lived Department 56 trademark and a decrease of \$127 to tangible assets. During 2007, the Company also paid or accrued additional earnout payments to Willitts for achieving certain performance thresholds. These earnout payments resulted in an increase in the Department 56 indefinite-lived trademarks of \$1,022.

During the second quarter of 2007, as part of the sale of certain of the Gorham sterling silver assets, the Company evaluated the Gorham trademark. Based on the results of this evaluation, the Company determined that \$647 of indefinite-life trademarks were to be included as part of the sale transaction that took place in the third quarter.

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Intangible asset amortization expense for the 13 weeks and 26 weeks ended June 28, 2008 was \$484 and \$982 respectively, compared to \$545 and \$1,118 for the second quarter and 26 weeks ended June 30, 2007, respectively.

Expected future amortization expense for finite-lived intangible assets is as follows:

|                  |    |        |
|------------------|----|--------|
| 2008 (full year) | \$ | 1,938  |
| 2009             |    | 1,846  |
| 2010             |    | 1,560  |
| 2011             |    | 1,242  |
| 2012             |    | 1,232  |
| Thereafter       |    | 4,166  |
|                  | \$ | 11,984 |

The above amortization expense forecast is an estimate. Actual amounts of amortization expense may differ from estimated amounts due to additional intangible asset acquisitions, impairment of intangible assets, accelerated amortization of intangible assets and other events.

### 10. Debt

Debt and the average interest rate on debt outstanding are summarized as follows:

|                                                                                   | June 28, 2008 |           |             | December 29, 2007 |          |             | June 30, 2007 |           |             |
|-----------------------------------------------------------------------------------|---------------|-----------|-------------|-------------------|----------|-------------|---------------|-----------|-------------|
|                                                                                   | Total         | Current   | Non current | Total             | Current  | Non current | Total         | Current   | Non current |
| Revolving credit facility<br>4.57%                                                | \$ 69,927     | \$ 69,927 | \$          | \$ 8,938          | \$ 8,938 | \$          | \$ 68,249     | \$ 68,249 | \$          |
| Note payable to Maryland<br>Department of Business and<br>Economic Development 3% | \$ 150        |           | 150         | 150               |          | 150         | 150           | 150       |             |
|                                                                                   | \$ 100        |           | 100         | 100               |          | 100         | 100           | 100       |             |

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Note payable to the County  
Commissioners of  
Washington County,  
Maryland 0%

|                          |            |           |           |            |           |           |            |           |           |
|--------------------------|------------|-----------|-----------|------------|-----------|-----------|------------|-----------|-----------|
| Term loan facility 7.41% | 99,000     | 1,250     | 97,750    | 99,500     | 1,250     | 98,250    | 99,750     | 1,000     | 98,750    |
| Total debt               | \$ 169,177 | \$ 71,177 | \$ 98,000 | \$ 108,688 | \$ 10,188 | \$ 98,500 | \$ 168,249 | \$ 69,499 | \$ 98,750 |

The note payable to the Maryland Department of Business and Economic Development is a conditional promissory note that accrues interest at 3% per year. The principal and interest payments were deferred until December 31, 2008 and thereafter are subject to multiple maturity dates determined by the Company's employment levels at the Hagerstown, MD distribution facility. The Company is also required to make a minimum capital investment to the distribution facility by December 31, 2008 in order to maintain this deferral status. The Company expects to meet the amended terms to allow for deferral of principal and interest payments through its next fiscal year. Accordingly, the note was classified as noncurrent long-term debt as of June 28, 2008.

The note payable to the County Commissioners of Washington County, Maryland is a conditional grant agreement that bears no interest charges. The principal payments were deferred until December 31, 2008 and thereafter are subject to multiple maturity dates determined by the Company's employment levels at the Hagerstown, MD distribution facility. The Company is also required to make a minimum capital investment to the distribution facility by December 31, 2008 in order to maintain this deferral status. The Company expects to meet the amended terms to allow for deferral of principal payments through its next fiscal year. Accordingly, the note was classified as noncurrent long-term debt as of June 28, 2008.

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On February 9, 2007, the Company entered into waivers and amendments to its revolving credit facility and term loan credit facility (the "credit facilities") in connection with the Company's noncompliance with certain financial covenants under the credit facilities for the period ended December 30, 2006. Pursuant to the waivers and amendments, the lenders granted the Company a limited waiver of noncompliance through and including April 30, 2007, and temporarily amended the agreements to adjust the leverage ratio and interest coverage ratio levels for the first quarter of 2007. In addition, the amendment to the term loan facility increased the applicable margin for loans by 0.25% per annum. As consideration for the amendments, the Company paid amendment fees of \$0.2 million.

On April 20, 2007, the Company completed the refinancing of its credit facilities by entering into amended and restated revolving and term loan facilities. The amended and restated revolving credit facility, which expires on April 20, 2012, provides for borrowings up to \$175 million, which may be in the form of letters of credit and revolving credit loans to be used for working capital and general corporate purposes. The amended and restated term loan facility, which expires on April 20, 2013, provides for term loans in the aggregate principal amount of up to \$100 million. The Company used the proceeds of the amended and restated term loan facility to refinance the \$47.4 million of term debt outstanding and \$42.2 million of the revolver debt outstanding at April 20, 2007, to pay \$1.2 million of accrued interest and fees payable under the existing credit facilities and to pay \$9.2 million of fees and expenses in connection with the refinancing.

Total fees and expenses incurred by the Company in connection with the refinancing were \$9.7 million (inclusive of the \$9.2 million paid out of the proceeds of the amended and restated term loan facility), of which \$7.0 million was capitalized and \$2.7 million was included as loss on refinancing of debt during the second quarter of 2007 in accordance with EITF 98-14, *Debtor's Accounting for Changes in Line-of-Credit or Revolving-Debt Arrangements* (EITF 98-14), and EITF 96-10, *Debtor's Accounting for a Modification or Exchange of Debt Instruments* (EITF 98-19). Based on these same criteria, the Company recognized an additional \$3.2 million loss on refinancing of debt during the second quarter of 2007 to write-off portions of the previously capitalized loan costs.

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Borrowings under the amended and restated revolving credit facility are subject to certain borrowing base limitations, and the Company's borrowing capacity fluctuates during the year based upon accounts receivable and inventory levels. As of June 28, 2008, the Company's borrowing capacity under the amended and restated revolving credit facility was \$95.5 million, of which \$17.3 million was available for additional borrowings or letters of credit at such date.

The amended and restated credit facilities are secured by a first-priority lien on substantially all of the real and personal property of the Company. In addition, the Company has pledged the common stock of its subsidiaries, direct and indirect, as collateral under the amended and restated credit facilities, and the Company and its material subsidiaries, direct and indirect, have guaranteed repayment of amounts borrowed under the amended and restated credit facilities.

The amended and restated revolving credit facility allows the Company to choose between two interest rate options in connection with its revolving credit loans. The interest rate options are the Alternate Base Rate (as defined) or the Adjusted LIBOR Rate (as defined) plus an applicable margin. The applicable margin ranges from 0% to 0.5% for Alternate Base Rate loans and from 1.75% to 2.25% for Adjusted LIBOR Rate loans. The amended and restated revolving credit facility also provides for commitment fees of 0.375% per annum on the daily average of the unused commitment.

The amended and restated term loan facility allows the Company to choose between two interest rate options in connection with its loans under the facility. The interest rate options are the Alternate Base Rate (as defined) or the Adjusted LIBOR Rate (as defined) plus an applicable margin. The applicable margin is 3.5% for Alternate Base Rate loans and 4.5% for Adjusted LIBOR Rate loans.

Under the amended and restated term loan facility, the Company is also obligated to make mandatory prepayments if certain events occur in the future such as certain asset sales, additional debt issuances, common and preferred stock issuances, and excess cash flow generation. Such prepayments will be applied to the term loan until it is paid in full, except for prepayments occurring upon the sale of designated revolving loan collateral, which will be applied to the revolving loan.

The amended and restated credit facilities contain customary financial conditions and covenants, including restrictions on additional indebtedness, liens, investments, capital expenditures, issuances of capital stock and dividends. The amended and restated credit facilities also require maintenance of minimum levels of fixed charge coverage and maximum levels of leverage, in each case at the end of each fiscal quarter. The minimum fixed charge coverage ratio (as defined within the credit facility agreements) requires the Company to maintain a minimum ratio of Consolidated EBITDA (as defined within the credit facility agreements) to Consolidated Fixed Charges (as defined within the credit facility agreements) over a 12-month period ending on each fiscal quarter. The maximum leverage ratio (as defined within the term credit facility agreement) requires the Company to maintain a maximum ratio of debt (as measured at the end of each fiscal quarter) to Consolidated EBITDA over a 12-month period ending on each fiscal quarter.

### 11. Benefit Plans

During the quarter ended September 29, 2007, the Company announced that it is discontinuing post-65 retiree medical and life insurance coverage for all current participants (except for eight retirees and their dependents which have individual agreements with the Company) effective September 1, 2007. In accordance with SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, the Company accounted for this discontinuation as a negative plan amendment, remeasured its obligation as of August 31, 2007, and reflected a negative prior service cost which is being amortized into net periodic benefit cost pursuant to the Company's historical accounting policy.

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Components of net periodic benefit cost for the 13 and 26 weeks ended June 28, 2008 and June 30, 2007 were as follows:

|                                    | 13 weeks ended   |                  | Medical and Life   |                  |
|------------------------------------|------------------|------------------|--------------------|------------------|
|                                    | Pension Benefits |                  | Insurance Benefits |                  |
|                                    | June 28,<br>2008 | June 30,<br>2007 | June 28,<br>2008   | June 30,<br>2007 |
| Service cost                       | \$ 113           | \$               | \$                 | \$               |
| Interest cost                      | 2,386            | 2,263            | 26                 | 237              |
| Expected return on assets          | (2,870 )         | (2,667 )         |                    |                  |
| Amortization of prior service cost |                  |                  | (345 )             | (175 )           |
| Amortization of gain               | (444 )           | (298 )           | (41 )              | (41 )            |
| Net periodic benefit cost          | \$ (815 )        | \$ (702 )        | \$ (360 )          | \$ 21            |

  

|                                    | 26 weeks ended   |                  | Medical and Life   |                  |
|------------------------------------|------------------|------------------|--------------------|------------------|
|                                    | Pension Benefits |                  | Insurance Benefits |                  |
|                                    | June 28,<br>2008 | June 30,<br>2007 | June 28,<br>2008   | June 30,<br>2007 |
| Service cost                       | \$ 227           | \$               | \$                 | \$               |
| Interest cost                      | 4,772            | 4,526            | 52                 | 474              |
| Expected return on assets          | (5,740 )         | (5,334 )         |                    |                  |
| Amortization of prior service cost |                  |                  | (690 )             | (350 )           |
| Amortization of gain               | (887 )           | (596 )           | (81 )              | (82 )            |
| Net periodic benefit cost          | \$ (1,628 )      | \$ (1,404 )      | \$ (719 )          | \$ 42            |

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## 12. Income Taxes

The reconciliation between income tax expense based on statutory income tax rates and the provision for income taxes is as follows:

|                                                       | 13 weeks ended   |                  | 26 weeks ended   |                  |
|-------------------------------------------------------|------------------|------------------|------------------|------------------|
|                                                       | June 28,<br>2008 | June 30,<br>2007 | June 28,<br>2008 | June 30,<br>2007 |
| Pretax Accounting Loss                                | \$ (23,825 )     | \$ (18,543 )     | \$ (37,618 )     | \$ (42,783 )     |
| Benefit for income taxes at federal statutory rate    | (8,339 )         | (6,490 )         | (13,166 )        | (14,794 )        |
| Trademark impairment                                  | (5,605 )         |                  | (5,605 )         |                  |
| Valuation allowance                                   | 40,829           |                  | 40,829           |                  |
| State income taxes, net of federal income tax benefit | (54 )            | (731 )           | 151              | (1,781 )         |
| Charitable donations of inventory                     |                  | (11 )            |                  | (57 )            |
| Adjustments to uncertain tax positions                | 11               |                  | (110 )           | (1,845 )         |
| Other                                                 | 6                |                  | 7                |                  |
| Provision (benefit) for income taxes                  | \$ 26,848        | \$ (7,232 )      | \$ 22,106        | \$ (18,477 )     |

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The valuation allowance for the 13 and 26 weeks ended June 28, 2008 applies to all of the deferred tax assets of the Company, including tax loss carryforwards, net of certain deferred tax liabilities. SFAS No. 109, Accounting for Income Taxes ( SFAS 109 ) requires a company to evaluate its deferred tax assets on a regular basis to determine if a valuation allowance against the net deferred tax assets is required. According to SFAS 109, a cumulative loss in recent years is significant negative evidence in considering whether deferred tax assets are realizable. Based on the negative evidence, SFAS 109 precludes relying on projections of future taxable income to support the recognition of deferred tax assets. Accordingly, a valuation allowance on federal and state deferred tax assets was established during the second quarter of 2008.

### 13. Commitments and Contingencies

#### *Legal Proceedings*

(A) Curiale v. Lenox Group Inc. On April 12, 2007, Amanda Curiale filed a complaint in the United States District Court for the Eastern District of Pennsylvania, which is a purported class action alleging that the Company willfully violated the Federal Fair and Accurate Credit Transactions Act ( FACTA ) by continuing to print after December 1, 2006 the expiration dates on receipts provided to debit card and credit cardholders transacting business with the Company (hereinafter the FACTA Litigation ). The Company understands that similar complaints have been filed against a large number of retailers. The plaintiff seeks, on behalf of herself and the class, statutory damages of not less than one hundred dollars and not more than one thousand dollars for each violation, as well as unspecified punitive damages, costs and attorneys' fees and a permanent injunction from further engaging in violations of FACTA.

On September 20, 2007, the parties held an all-day mediation session and reached a tentative settlement which is subject to court approval. Under the terms of the settlement, Lenox denies all claims as to liability, damages, penalties, interest, fees, restitution and all other forms of relief sought in the FACTA Litigation. Pursuant to the terms of the proposed settlement, the Company will pay approximately \$128 for attorney's fees and costs, a charitable contribution and a plaintiff's incentive fee, and will provide participating claimants with a coupon off a future purchase or a free product through Company-operated retail stores. In return, the Company and its affiliates will be completely released from any and all claims, demands and actions concerning the FACTA Litigation and any claims that could have been alleged in the FACTA litigation.

As a result of the Credit and Debit Card Receipt Clarification Act of 2007 enacted on June 3, 2008, the Company is seeking a dismissal of this action with prejudice. Plaintiffs have opposed a dismissal and seek Court approval of the tentative settlement. The parties are awaiting a decision by the Court.

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(B) Period Design, Inc. v. D56, Inc. ( D56 ) D56 is a subsidiary of the Company. Plaintiff alleged a breach of contract claim and sought compensatory damages of several million dollars based upon D56's alleged failure to pay royalties alleged to be due Period Design, Inc. on various products marketed and sold by D56, together with pre-judgment interest thereon. The matter was tried before the Minnesota State District Court (Hennepin County) from February 17 through February 28, 2008. On August 5, 2008, the Court issued its Findings of Fact, Conclusions of Law and Order pursuant to which the Company was ordered to pay \$205,447 in excess royalties to Period Design. The Company has adequately accrued for liabilities related to this case.

In addition to the above actions, the Company is involved in various legal proceedings, claims and governmental audits in the ordinary course of its business. The Company believes it has meritorious defenses to all proceedings, claims and audits. Management believes the impact, if any, of these legal proceedings would not be material to the results of operations, financial position or cash flows of the Company.

# 14. Stockholders' Equity

The components of stockholders' equity are as follows:

|                                                                                                                    | June 28,<br>2008 | December 29,<br>2007 | June 30,<br>2007 |
|--------------------------------------------------------------------------------------------------------------------|------------------|----------------------|------------------|
| Preferred stock, \$.01 par value; authorized 20,000 shares; no shares issued                                       | \$               | \$                   | \$               |
| Common stock, \$.01 par value; authorized 100,000 shares;<br>issued 23,982, 23,615 and 23,425 shares, respectively | 240              | 236                  | 234              |
| Additional paid-in capital                                                                                         | 64,382           | 64,021               | 63,509           |
| Treasury stock, at cost; 9,552, 9,418 and 9,413 shares,<br>respectively                                            | (217,239 )       | (217,227 )           | (217,216 )       |
| Retained earnings                                                                                                  | 190,577          | 250,301              | 241,821          |
| Accumulated other comprehensive income                                                                             | 37,157           | 38,811               | 27,741           |
| Total stockholders' equity                                                                                         | \$75,117         | \$136,142            | \$116,089        |

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# 15. Segments of the Company and Related Information

The Company has three reportable segments: Wholesale, Retail and Direct. Although the product produced and sold for each segment is similar, the types of customers for the product and the methods used to distribute the product are different. The segmentation of these operations also reflects how the Company's chief executive officer currently reviews the results of these operations. Operating income (loss) for each operating segment includes specifically identifiable operating costs such as cost of sales and selling expenses. General and administrative expenses are generally not allocated to specific operating segments and are therefore reflected in the Corporate category. Other components of the statement of operations, which are classified below operating income (loss), are also not allocated by segment. In addition, the Company does not account for or report assets, capital expenditures or certain depreciation and amortization by segment. All transactions between operating segments have been eliminated and are not included in the following table.

|              | 13 WEEKS<br>ENDED<br>JUNE 28,<br>2008 |                      | 13 WEEKS<br>ENDED<br>JUNE 30,<br>2007 |                      | 26 WEEKS<br>ENDED<br>JUNE 28,<br>2008 |                      | 26 WEEKS<br>ENDED<br>JUNE 30,<br>2007 |                      |
|--------------|---------------------------------------|----------------------|---------------------------------------|----------------------|---------------------------------------|----------------------|---------------------------------------|----------------------|
|              |                                       | % of<br>net<br>sales |                                       | % of<br>net<br>sales |                                       | % of<br>Net<br>sales |                                       | % of<br>net<br>sales |
| WHOLESALE:   |                                       |                      |                                       |                      |                                       |                      |                                       |                      |
| Net sales    | \$57,267                              | 100                  | \$67,692                              | 100                  | \$102,077                             | 100                  | \$117,987                             | 100                  |
| Gross profit | 26,917                                | 47                   | 28,300                                | 42                   | 47,637                                | 47                   | 46,929                                | 40                   |

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|                          |           |       |           |       |            |       |            |       |
|--------------------------|-----------|-------|-----------|-------|------------|-------|------------|-------|
| Selling expenses         | 8,542     | 15    | 8,684     | 13    | 17,338     | 17    | 16,916     | 14    |
| Restructuring charges    | 77        | 0     | 86        | 0     | 77         | 0     | 687        | 1     |
| Operating income         | 18,298    | 32    | 19,530    | 29    | 30,222     | 30    | 29,326     | 25    |
| <b>RETAIL:</b>           |           |       |           |       |            |       |            |       |
| Net sales                | \$ 7,468  | 100   | \$ 9,197  | 100   | \$ 16,663  | 100   | \$ 25,550  | 100   |
| Gross profit             | 3,536     | 47    | 3,875     | 42    | 7,892      | 47    | 8,601      | 34    |
| Selling expenses         | 5,932     | 79    | 7,125     | 77    | 12,587     | 76    | 15,218     | 60    |
| Restructuring charges    | 10        | 0     | 598       | 7     | 25         | 0     | 951        | 4     |
| Impairment loss          | 2,588     | 35    |           | 0     | 2,588      | 16    |            | 0     |
| Operating loss           | (4,994 )  | (67 ) | (3,848 )  | (42 ) | (7,308 )   | (44 ) | (7,568 )   | (30 ) |
| <b>DIRECT:</b>           |           |       |           |       |            |       |            |       |
| Net sales                | \$ 11,279 | 100   | \$ 15,818 | 100   | \$ 28,466  | 100   | \$ 34,942  | 100   |
| Gross profit             | 8,206     | 73    | 10,874    | 69    | 19,728     | 69    | 23,511     | 67    |
| Selling expenses         | 7,278     | 65    | 10,010    | 63    | 16,463     | 58    | 21,203     | 61    |
| Restructuring charges    | 17        | 0     | 165       | 1     | 22         | 0     | 165        | 0     |
| Operating income         | 911       | 8     | 699       | 4     | 3,243      | 11    | 2,143      | 6     |
| <b>CORPORATE:</b>        |           |       |           |       |            |       |            |       |
| Unallocated net sales    | \$ 195    |       | \$ 264    |       | \$ 401     |       | \$ 886     |       |
| Unallocated G&A expenses | 20,322    |       | 24,041    |       | 41,804     |       | 49,770     |       |
| Trademark Impairment     | 14,226    |       |           |       | 14,226     |       |            |       |
| Restructuring charges    | 325       |       | 1,228     |       | 1,394      |       | 5,065      |       |
| Operating loss           | (34,678 ) |       | (25,005 ) |       | (57,023 )  |       | (53,949 )  |       |
| <b>CONSOLIDATED:</b>     |           |       |           |       |            |       |            |       |
| Net sales                | \$ 76,209 | 100   | \$ 92,971 | 100   | \$ 147,607 | 100   | \$ 179,365 | 100   |
| Operating income (loss)  | (20,463 ) | (27 ) | (8,624 )  | (9 )  | (30,866 )  | (21 ) | (30,048 )  | (17 ) |

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

### RESULTS OF OPERATIONS

This Item should be read in conjunction with the Condensed Consolidated Financial Statements and the related notes, particularly Note 15, presented earlier in this Quarterly Report on Form 10-Q. Other components of the Condensed Consolidated Statement of Operations which are classified below Operating Income (i.e. interest expense, income tax expense (benefit), etc.) are not allocated by segment and are discussed separately.

### *Comparison of Results of Operations for the Quarter Ended June 28, 2008 to the Quarter Ended June 30, 2007.*

#### Wholesale

Net sales decreased \$10.4 million, or 15%, in the second quarter of 2008, compared with the same period in 2007 on lower sales volume. The lower volume was due primarily to current economic conditions which have resulted in an extremely weak retail environment, particularly for discretionary products such as those sold by the Company. The gift and specialty channel has been impacted the most. The sale of the Gorham

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sterling silver product line in the third quarter of 2007 also contributed to the volume decline.

Gross profit decreased \$1.4 million in the second quarter of 2008 as compared to the second quarter of 2007 primarily due to lower sales volume and a significant amount of liquidation pricing in 2008. Lower product costs due principally to manufacturing improvements, including those at the Kinston factory were a partial offset. Gross profit as a percentage of net sales was 47% and 42% in the second quarter of 2008 and 2007, respectively. A lower excess inventory provision contributed 3% to the margin percentage improvement, while lower product costs lead to an additional 2% improvement.

Selling expenses were 15% of net sales in the second quarter of 2008 as compared to 13% in the second quarter of 2007. The higher rate reflects slightly lower expenses on a lower sales base.

Operating income decreased in the second quarter of 2008 by \$1.2 million as compared to the comparable period in 2007 due primarily to the sales volume decline.

### Retail

Net sales decreased \$1.7 million, or 19%, in the second quarter of 2008, compared with the same period in 2007. Lower sales volume, due to a weak retail environment, resulted in a 12% reduction in same store sales. An average of four fewer retail stores in the second quarter of 2008 as compared to the comparable prior year period, also contributed to the volume decline.

Gross profit decreased only \$0.3 million in the second quarter of 2008 compared to the second quarter of 2007. Lower sales volume was partially offset by a heavier mix of high gross margin first quality and go-forward merchandise sold in the second quarter of 2008 as compared to lower gross margin excess merchandise sold in the second quarter of 2007. Gross profit as a percentage of net sales was 47% in the second quarter of 2008 versus 42% in the second quarter of 2007. The 5% increase in gross profit percentage was primarily due to a heavier mix of high gross margin first quality and go-forward merchandise sold in the second quarter of 2008 as compared to lower gross margin excess merchandise sold in the second quarter of 2007.

Selling expenses decreased \$1.2 million in the second quarter of 2008 compared to the same period in 2007, primarily as a result of fewer stores.

Restructuring charges of \$0.6 million in the second quarter of 2007 were principally due to lease termination cost related to the termination of an All the Hoopla store lease and to severance related charges.

Impairment charges of \$2.6 million in the second quarter of 2008 related to the write-down of the fixed assets of three former All the Hoopla stores. These stores had historically generated negative operating cash flow and were projected to continue to this trend into the foreseeable future.

Operating loss was \$1.1 million more in the second quarter of 2008 as compared to the second quarter of 2007 due to the impairment charges.

### Direct

Net sales decreased \$4.5 million, or 29%, in the second quarter of 2008 as compared to the same period in 2007 on lower sales volume. The volume decline was due primarily to a planned reduction in promotion frequency in the direct mail business, targeting a historically higher responding customer group, which was intended to increase customer response rates. Lower catalog and internet sales also contributed to the volume decrease.

Gross profit decreased \$2.7 million in the second quarter of 2008 as compared to the second quarter of 2007, principally due to the decrease in sales volume. Gross profit as a percentage of net sales was 73% and 69% in the second quarter of 2008 and 2007, respectively. The 4% increase in gross profit percentage was primarily due to a more favorable product mix.

Selling expenses decreased by \$2.7 million, or 27%, in the second quarter of 2008 compared to the same period in 2007. This decrease in selling expense in 2008 was primarily due to a planned decrease in advertising spending designed to maximize operating income by concentrating on programs with the highest customer response rates.

Restructuring charges of \$0.2 million in the second quarter of 2007 were severance-related charges.

Operating income increased by \$0.2 million or 30% in the second quarter of 2008 compared to the same period in 2007 due to gross profit improvements and cost reductions.

### Corporate

Net sales of \$0.2 million and \$0.3 million in the second quarters of 2008 and 2007, respectively, represents revenue from the licensing of the Lenox brand.

General and administrative expenses decreased by \$3.7 million, or 15%, in the second quarter of 2008 as compared to the same period in 2007. This decrease was primarily due to a \$1.1 million reduction in base and incentive compensation and benefit related costs, \$0.8 million from reduced distribution costs and \$0.5 million in pension and postretirement savings. An additional decrease of \$1.0 million resulted principally from lower executive management fees, legal fees and other cost savings.

The Company performed an impairment analysis of its intangible assets as of June 28, 2008 as a result of declining revenues. Based on the results of this analysis, the Company determined that the carrying value of the Department 56 and Gorham trademarks exceeded their fair values. The Company recorded an impairment charge of \$14.2 million in the second quarter of 2008, \$13.0 million related to the Department 56 trademark and \$1.2 million related to the Gorham trademark.

Restructuring charges of \$0.3 million in the second quarter of 2008 and \$1.2 million in the second quarter of 2007 were principally severance costs related to headcount reductions.

Loss on the debt refinancing

The Company incurred a \$5.9 million loss on refinancing its term and revolver loans in the second quarter of 2007.

Provision for Income Taxes

The Company recorded tax expense of \$26.8 million in the second quarter of 2008, which included \$40.8 million in tax expense related to a valuation allowance against the net deferred tax asset balance at June 28, 2008. SFAS No. 109, *Accounting for Income Taxes* ( SFAS 109 ), requires a company to evaluate its deferred tax assets on a regular basis to determine if a valuation allowance against the net deferred tax assets is required. According to SFAS 109, a cumulative loss in recent years is significant negative evidence in considering whether deferred tax assets are realizable. Based on this negative evidence, SFAS 109 precludes relying on projections of future taxable income to support the realizability of deferred tax assets. The Company determined that a full valuation allowance was necessary against all existing federal and state net deferred tax assets as of June 28, 2008, based on the results of this evaluation. (See Note 12 to the Condensed Consolidated Financial Statements)

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*Comparison of Results of Operations for the 26 Weeks Ended June 28, 2008 to the 26 Weeks Ended June 30, 2007.*

Wholesale

Net sales decreased \$15.9 million, or 13%, in the first half of 2008 compared with the same period in 2007 due to lower sales volume. The volume decline was due primarily to current economic conditions which have resulted in an extremely weak retail environment, particularly for discretionary products such as those sold by the Company. The gift and specialty channel has been impacted the most. The sale of the Gorham sterling silver product line in the third quarter of 2007 also contributed to the volume decline.

Gross profit increased \$0.7 million in the first half of 2008 as compared to the first half of 2007 as a more favorable product mix and a lower excess inventory provision more than offset the decline in sales volume. Gross profit as a percentage of net sales improved 7% from 40% in the first half of 2007 to 47% in the first half of 2008. The higher gross profit percentage was the result of lower product costs, principally due to manufacturing improvements, including those at the Kinston factory, which contributed 6% to the improvement. A lower excess inventory provision also contributed to the gross profit percentage improvement.

Selling expenses were 17% of net sales in the first half of 2008 as compared to 14% in the first half of 2007. The higher rate reflects slightly higher advertising expense on a lower sales base.

2007 results included \$0.7 million of severance-related restructuring charges largely not repeated in 2008.

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Operating income increased \$0.9 million in the first six months of 2008 as compared to the same period in 2007 primarily due to the improvement in gross margin percentage as described above.

### Retail

Net sales decreased \$8.9 million, or 35%, in the first half of 2008, compared with the same period in 2007 on lower sales volume. Sales volume in the first half of 2007 was driven by excessive price reductions to liquidate excess merchandise, which was not repeated in 2008. As a result, same stores sales in the first half of 2008 declined 28%. The weak retail environment which lead to lower outlet mall and store traffic and a net reduction of six stores in the first half of 2008, as compared to the comparable prior period, also contributed to the volume decline.

Gross profit decreased only \$0.7 million in the first half of 2008 compared to the first half of 2007 as a favorable product mix was able to offset a significant portion of the volume decline. Gross profit as a percentage of net sales improved 13% from 34% in the first half of 2007 to 47% in the first half of 2008. A greater mix of high gross margin first quality and go-forward merchandise sold in the first half of 2008 as compared to lower gross margin excess merchandise sold in the first half of 2007 accounted for 11% of the gross margin percentage improvement.

Selling expenses decreased \$2.6 million in the first half of 2008 compared to the first half of 2007, primarily as a result of fewer stores. Selling expenses increased as a percentage of net sales from 60% in the first half of 2007 to 76% in the first half of 2008. This higher expense rate reflects reduced operating expenses on a significantly smaller net sales base

Restructuring charges of \$1.0 million in the first half of 2007 were related to lease termination and other store closure costs with respect to two store locations, as well as severance-related charges.

Impairment charges of \$2.6 million in the first half of 2008 related to the write-down of the fixed assets of three former All the Hoopla stores. These stores had historically generated negative operating cash flow and were projected to continue to this trend into the foreseeable future.

Operating loss was \$0.3 million less in the first half of 2008 as compared to the first half of 2007, due primarily to the gross margin improvements.

### Direct

Net sales decreased \$6.5 million, or 19%, in the first half of 2008 as compared to the same period in 2007 on lower sales volume. The volume decline was primarily due to a planned reduction in promotion frequency in the direct mail business, targeting a historically higher responding customer group, intended to increase customer response rates. Lower catalog sales also contributed to the decline.

Gross profit decreased \$3.8 million in the first half of 2008 as compared to the first half of 2007, due to the decrease in sales volume. Gross profit as a percentage of net sales was 69% and 67% in the first half of 2008 and 2007, respectively. This increase in gross profit percentage was primarily due to a lower provision for excess inventory and fewer product returns in the first half of 2008 versus the comparable prior year

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period.

Selling expenses decreased by \$4.7, million or 22%, in the first half of 2008 compared to the first half of 2007 due primarily to a planned decrease in advertising spending to maximize operating income by concentrating on programs with the highest customer response rates.

Restructuring charges of \$0.2 million in 2007 were severance-related charges that were largely not repeated in 2008.

Operating income increased by \$1.1 million, or 51%, in the first half of 2008 compared to the same period in 2007 primarily due to the gross margin improvement and expense reductions.

### Corporate

Net sales of \$0.4 million in the first half of 2008 represents revenue from the licensing of the Lenox brand and was \$0.5 million lower compared with the first half of 2007.

General and administrative expenses decreased by \$8.0 million, or 16%, in the first six months of 2008 as compared to the same period in 2007. This decrease was primarily a result of a \$2.8 million reduction in base and incentive compensation and benefit related costs, \$2.0 million from reduced distribution costs and \$1.0 million in pension and postretirement savings. An additional decrease of \$3.3 million resulted principally from lower executive management fees, legal fees and other cost savings. The first half of 2007 benefited from a reversal of equity compensation expense related to the forfeiture of certain performance shares, which did not re-occur in the first half of 2008. As a result, equity compensation increased \$1.1 million in the first half of 2008 as compared to the first half of 2007.

The Company performed an impairment analysis of its intangible assets as of June 28, 2008, as a result of declining revenues. Based on the results of this analysis, the Company determined that the carrying value of the Department 56 and Gorham trademarks exceeded their fair values. The Company recorded an impairment charge of \$14.2 million in the first half of 2008, \$13.0 million related to the Department 56 trademark and \$1.2 million related to the Gorham trademark.

Restructuring charges of \$1.4 million in the first half of 2008 were primarily exit costs related to the closure of the Rogers, MN distribution center that was completed in the first quarter of 2008. Additional 2008 restructuring charges were severance-related costs. Restructuring charges of \$5.1 million in the first half of 2007 were principally severance expense related to the Company's previous chief executive officer, lease buyout expense related to the shutdown of the Company's Rogers distribution facility and general severance and other costs associated with organizational changes.

### Loss on the debt refinancing

The Company incurred a \$5.9 million loss on refinancing of its term and revolver loans in the first half of 2007. This loss consisted of \$2.7 million of costs incurred in the quarter related to the re-financing as well as the write-off of \$3.2 million of previously capitalized loan costs.

Provision for Income Taxes

The Company recorded tax expense of \$22.1 million for the first half of 2008 which included \$40.8 million in tax expense related to a valuation allowance against the net deferred tax asset balance at June 28, 2008. SFAS No. 109, *Accounting for Income Taxes* ( SFAS 109 ), requires a company to evaluate its deferred tax assets on a regular basis to determine if a valuation allowance against the net deferred tax assets is required. According to SFAS 109, a cumulative loss in recent years is significant negative evidence in considering whether deferred tax assets are realizable. Based on this negative evidence, SFAS 109 precludes relying on projections of future taxable income to support the realizability of deferred tax assets. The Company determined that a full valuation allowance was necessary against all existing federal and state net deferred tax assets as of June 28, 2008 based on the results of this evaluation. (see Note 12 to the Condensed Consolidated Financial Statements)

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**SEASONALITY**

The Company's business is highly seasonal. It has historically recorded its highest Wholesale segment sales during the third and fourth quarters of each year as Wholesale customers stock merchandise in anticipation of the holiday season. In addition, the Company records its highest Retail and Direct segment sales in the fourth quarter during the peak holiday shopping season. However, the Company can experience fluctuations in quarterly sales and related net income compared with the prior year due to the timing of receipt of product from suppliers and subsequent shipment of product from the Company to customers, as well as the timing of orders placed by customers. Due to the seasonality of segment sales as indicated above, the Company has historically operated at a loss during the first nine months of the fiscal year. The Company is not managed to maximize quarter-to-quarter results, but rather to achieve annual objectives designed to achieve long-term growth consistent with the Company's business strategy.

**LIQUIDITY AND CAPITAL RESOURCES**

The Company's primary sources of cash are the funds generated from operations and its revolving credit facility, which is available for working capital and investment needs.

Consistent with customary practice in the giftware industry, the Company offers extended payment terms to some of its Wholesale customers. This practice has created significant working capital requirements as the Company uses cash to source inventory, but does not receive cash from its customers until the fourth quarter and early first quarter of the subsequent year, when the extended payment terms come due. Similarly, the Company's Retail and Direct segments create working capital requirements during the first nine months of the year with revenue and cash collections peaking during the holiday season in the fourth quarter and early first quarter of the subsequent year. The Company finances these working capital requirements with seasonal borrowings under its revolving credit facility. Cash collected in the fourth quarter and first quarter of the subsequent year is used to repay the seasonal borrowings.

The timing of cash payments to suppliers of inventory, the ability to ship inventory to its customers, and the timing of cash receipts from its customers will impact the Company's borrowing base capacity. The Company monitors accounts receivable, inventory levels and shipment of products on a routine basis to ensure adequate borrowing base capacity exists to fund its current working capital needs.

Due in part to the negative impact of current economic and retail market conditions, the Company does not expect to remain in compliance with its financial covenants at the end of the third quarter of 2008. The Company's ability to continue with its current capital and operating structure

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and to fund operations would be contingent upon the Company's ability to negotiate a waiver with its lenders and/or restructure its outstanding indebtedness. There is currently no assurance that such a waiver can be obtained or that such a restructuring can occur. However, the Company is currently pursuing certain actions to strengthen its balance sheet and reduce indebtedness, and has commenced discussions with its term loan and credit facility lenders to restructure its outstanding indebtedness.

### Cash Flows from Operations

In the first half of 2008, operations consumed \$58.8 million in cash compared to \$61.2 million in the first half of 2007. Operating cash flow in the first half of both years reflects the seasonal working capital requirements of the business as noted above. The \$2.4 million decrease in cash consumed was principally due to a lower net loss in the first half of 2008, partially offset by an increase in working capital requirements. Working capital increased in 2008 as a result of purchasing inventory earlier than in 2007 in order to improve on delivery. Excess inventory, liquidated in the first half of 2007 generated cash which helped to offset working capital needs. This liquidation event was not repeated in the first half of 2008.

### Cash Flows from Investing Activities

In the first half of 2008, the Company used \$4.3 million of net cash in investing activities, due principally to capital spending in the distribution facilities as a result of the consolidation of the Roger's MN distribution center. In the first half of 2007, the Company used \$1.4 million for investing activities, primarily capital spending on facilities and technology infrastructure.

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### Cash Flows from Financing Activities

The Company had net borrowings of \$60.5 million under its revolving credit facility to fund operations in the first half of 2008 compared to borrowings of \$71.6 million for the same period in 2007. The \$11.1 million decrease in borrowings resulted principally from costs to re-finance the Company's debt in the second quarter of 2007 (see below) that were not repeated in 2008.

On February 9, 2007, the Company entered into waivers and amendments to its revolving credit facility and term loan credit facility (the "credit facilities") in connection with the Company's noncompliance with certain financial covenants under the credit facilities for the period ended December 30, 2006. Pursuant to the waivers and amendments, the lenders granted the Company a limited waiver of noncompliance through and including April 30, 2007, and temporarily amended the agreements to adjust the leverage ratio and interest coverage ratio levels for the first quarter of 2007. In addition, the amendment to the term loan facility increased the applicable margin for loans by 0.25% per annum. As consideration for the amendments, the Company paid amendment fees of \$0.2 million.

On April 20, 2007, the Company completed the refinancing of its credit facilities by entering into amended and restated revolving and term loan facilities. The amended and restated revolving credit facility, which expires on April 20, 2012, provides for borrowings up to \$175 million, which may be in the form of letters of credit and revolving credit loans to be used for working capital and general corporate purposes. The amended and restated term loan facility, which expires on April 20, 2013, provides for term loans in the aggregate principal amount of up to \$100 million. The Company used the proceeds of the amended and restated term loan facility to refinance the \$47.4 million of term debt

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outstanding and \$42.2 million of the revolver debt outstanding at April 20, 2007, to pay \$1.2 million of accrued interest and fees payable under the existing credit facilities and to pay \$9.2 million of fees and expenses in connection with the refinancing.

Total fees and expenses incurred by the Company in connection with the refinancing were \$9.7 million (inclusive of the \$9.2 million paid out of the proceeds of the amended and restated term loan facility), of which \$7.0 million was capitalized and \$2.7 million was included as loss on refinancing of debt during the second quarter of 2007 in accordance with EITF 98-14, *Debtor's Accounting for Changes in Line-of-Credit or Revolving-Debt Arrangements* ( EITF 98-14 ), and EITF 96-19, *Debtor's Accounting for a Modification or Exchange of Debt Instruments* ( EITF 96-19 ). Based on these same criteria, the Company recognized an additional \$3.2 million of loss on early extinguishment of debt during the second quarter of 2007 to write-off portions of the previously capitalized loan costs.

Borrowings under the amended and restated revolving credit facility are subject to certain borrowing base limitations, and the Company's borrowing capacity fluctuates during the year based upon accounts receivable and inventory levels. As of June 28, 2008, the Company's borrowing capacity under the amended and restated revolving credit facility was \$95.5 million, of which \$17.3 million was available for additional borrowings or letters of credit at such date.

The amended and restated credit facilities are secured by a first-priority lien on substantially all of the real and personal property of the Company. In addition, the Company has pledged the common stock of its subsidiaries, direct and indirect, as collateral under the amended and restated credit facilities, and the Company and its material subsidiaries, direct and indirect, have guaranteed repayment of amounts borrowed under the amended and restated credit facilities.

The amended and restated revolving credit facility allows the Company to choose between two interest rate options in connection with its revolving credit loans. The interest rate options are the Alternate Base Rate (as defined) or the Adjusted LIBOR Rate (as defined) plus an applicable margin. The applicable margin ranges from 0% to 0.5% for Alternate Base Rate loans and from 1.75% to 2.25% for Adjusted LIBOR Rate loans. The amended and restated revolving credit facility also provides for commitment fees of 0.375% per annum on the daily average of the unused commitment.

The amended and restated term loan facility allows the Company to choose between two interest rate options in connection with its loans under the facility. The interest rate options are the Alternate Base Rate (as defined) or the Adjusted LIBOR Rate (as defined) plus an applicable margin. The applicable margin is 3.5% for Alternate Base Rate loans and 4.5% for Adjusted LIBOR Rate loans.

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Under the amended and restated term loan facility, the Company is also obligated to make mandatory prepayments if certain events occur in the future such as certain asset sales, additional debt issuances, common and preferred stock issuances, and excess cash flow generation. Such prepayments will be applied to the term loan until it is paid in full, except for prepayments occurring upon the sale of designated revolving loan collateral, which will be applied to the revolving loan.

The amended and restated credit facilities contain customary financial conditions and covenants, including restrictions on additional indebtedness, liens, investments, capital expenditures, issuances of capital stock and dividends. The amended and restated credit facilities also require maintenance of minimum levels of fixed charge coverage and maximum levels of leverage, in each case at the end of each fiscal quarter. The minimum fixed charge coverage ratio (as defined within the credit facility agreements) requires the Company to maintain a minimum ratio of Consolidated EBITDA (as defined within the credit facility agreements) to Consolidated Fixed Charges (as defined within the credit facility

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agreements) over a 12-month period ending on each fiscal quarter. The maximum leverage ratio (as defined within the term credit facility agreement) requires the Company to maintain a maximum ratio of debt (as measured at the end of each fiscal quarter) to Consolidated EBITDA over a 12-month period ending on each fiscal quarter. The Company was in compliance with all financial covenants as of June 28, 2008.

### OFF-BALANCE SHEET ARRANGEMENTS

The Company does not have off-balance sheet arrangements.

### CONTRACTUAL OBLIGATIONS

As of June 28, 2008, the Company is obligated to make cash payments in connection with its debt obligations, operating leases, purchase commitments, capital leases, environmental remediation costs and royalty guarantees in the amounts listed below. The contractual obligation table below excludes the Company's FIN 48 liabilities of \$1,325 because the Company cannot make a reasonable estimate of the timing of the related cash payment. The Company has no unrecorded obligations other than the items noted in the following table:

|                                          | Payments due (in thousands) |          |          |          |         |            |           |
|------------------------------------------|-----------------------------|----------|----------|----------|---------|------------|-----------|
|                                          | 2008 (Q3-Q4)                | 2009     | 2010     | 2011     | 2012    | Thereafter | Total     |
| Revolving Credit Facility <sup>1,2</sup> | \$69,927                    |          |          |          |         |            | \$69,927  |
| Long-term Debt <sup>2</sup>              | 750                         | 1,000    | 1,000    | 1,000    | 750     | 94,750     | 99,250    |
| Operating Leases                         | 6,981                       | 13,313   | 11,863   | 10,370   | 8,854   | 44,315     | 95,696    |
| Purchase Commitments <sup>3</sup>        | 34,106                      |          |          |          |         |            | 34,106    |
| Capital leases                           |                             |          |          |          |         |            |           |
| Environmental Costs <sup>4</sup>         | 120                         | 214      | 209      | 205      | 290     | 973        | 2,011     |
| Royalty Guarantees <sup>5</sup>          | 229                         | 700      | 238      | 20       | 10      | 0          | 1,197     |
| Total                                    | \$112,113                   | \$15,227 | \$13,310 | \$11,595 | \$9,904 | \$140,038  | \$302,187 |

<sup>1</sup>The Company's borrowings under the revolving credit facility are classified as current liabilities on the Consolidated Balance Sheets in accordance with Emerging Issues Task Force Issue No. 95-22, *Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements That Include both a Subjective Acceleration Clause and a Lock-Box Arrangement*.

<sup>2</sup>In addition to the principal payments on debt included in the summary of significant contractual obligations, the Company will incur interest expense on outstanding variable rate debt. All amounts outstanding under the revolving and term loan credit facilities are variable interest rate debt with weighted average interest rates as of June 28, 2008 of 4.57 % and 7.41 %, respectively.

<sup>3</sup>The Company is committed to pay suppliers of product under the terms of open purchase orders issued in the normal course of business.

<sup>4</sup>The Company is responsible for the cleanup and/or monitoring of two environmental sites located in New Jersey.

<sup>5</sup>The Company is committed to pay licensors under the terms of license agreements entered into in the normal course of business.

Other than noted in the above table, there were no other material changes in contractual obligations from those disclosed in the Company's 2007 Form 10-K.

### CRITICAL ACCOUNTING POLICIES

There were no material changes in the Company's critical accounting policies from those described in the Company's 2007 Form 10-K.

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## **FORWARD-LOOKING STATEMENTS**

Any conclusions or expectations expressed in, or drawn from, the statements in this filing concerning matters that are not historical corporate financial results are forward-looking statements, within the meaning of the Private Securities Litigation Reform Act of 1995, that involve risks and uncertainties. These statements are based on management's estimates, assumptions and projections as of today and are not guarantees of future performance. Such risks and uncertainties that could affect performance include, but are not limited to, the ability of the Company to: (1) integrate certain Lenox and Department 56 operations; (2) achieve revenue or cost synergies; (3) generate cash flow to pay off outstanding debt and remain in compliance with the terms of its credit facilities; (4) successfully complete its operational improvements, including improving inventory management and making the supply chain more efficient; (5) retain key employees; (6) maintain and develop cost effective relationships with foreign manufacturing sources; (7) maintain the confidence of and service effectively key wholesale customers; (8) manage currency exchange risk and interest rate changes on the Company's variable debt; (9) identify, hire and retain quality designers, sculptors and artistic talent to design and develop products which appeal to changing consumer preferences; (10) successfully implement a strategic alternative including but not limited to the possible sale of the Department 56 business and actions to strengthen its balance sheet and reduce indebtedness; (11) forecast and react to consumer demand in a challenging economic environment; (12) raise capital in light of the delisting of our common stock from the New York Stock Exchange and (13) manage litigation risk in a cost effective manner. Actual results may vary materially from forward-looking statements and the assumptions on which they are based. The Company undertakes no obligation to update or publish in the future any forward-looking statements. Also, please read the bases, assumptions and factors set out in Item 1A in the Company's Form 10-K for 2007 dated March 13, 2008 and in Item 1A in the Company's Quarterly Reports on Form 10-Q that have been subsequently filed under the Securities Exchange Act of 1934 (The Exchange Act), all of which is incorporated herein by reference and applicable to the forward-looking statements set forth herein.

## **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

There has been no significant change in the Company's exposure to market risk since the end of fiscal 2007. The Company's market risks relate primarily to changes in interest rates and currency exchange rates. See Item 7A in the Company's 2007 Form 10-K for a discussion of these market risks.

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

### Disclosure Controls and Procedures

Lenox Group Inc. management is responsible for establishing and maintaining effective disclosure controls and procedures, as defined under Rule 13a-15(e) of the Exchange Act. As of the end of the period covered by this report, the Company performed an evaluation, under the supervision and with the participation of the Company's management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures. Based upon, and as of the date of that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures were effective to ensure that information required to be disclosed by the Company in the reports that it files or submits to the Securities and Exchange Commission (SEC) under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such

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information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

### Internal Controls Over Financial Reporting

No changes were made to the Company's internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) during the last fiscal quarter that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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## **PART II - OTHER INFORMATION**

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

(A) Curiale v. Lenox Group Inc. On April 12, 2007, Amanda Curiale filed a complaint in the United States District Court for the Eastern District of Pennsylvania, which is a purported class action alleging that the Company willfully violated the Federal Fair and Accurate Credit Transactions Act ( FACTA ) by continuing to print after December 1, 2006 the expiration dates on receipts provided to debit card and credit cardholders transacting business with the Company (hereinafter the FACTA Litigation ). The Company understands that similar complaints have been filed against a large number of retailers. The plaintiff seeks, on behalf of herself and the class, statutory damages of not less than one hundred dollars and not more than one thousand dollars for each violation, as well as unspecified punitive damages, costs and attorneys' fees and a permanent injunction from further engaging in violations of FACTA.

On September 20, 2007, the parties held an all-day mediation session and reached a tentative settlement which is subject to court approval. Under the terms of the settlement, Lenox denies all claims as to liability, damages, penalties, interest, fees, restitution and all other forms of relief sought in the FACTA Litigation. Pursuant to the terms of the proposed settlement, the Company will pay approximately \$128 for attorney's fees and costs, a charitable contribution and a plaintiff's incentive fee, and will provide participating claimants with a coupon off a future purchase or a free product through Company-operated retail stores. In return, the Company and its affiliates will be completely released from any and all claims, demands and actions concerning the FACTA Litigation and any claims that could have been alleged in the FACTA litigation.

As a result of the Credit and Debit Card Receipt Clarification Act of 2007 enacted on June 3, 2008, the Company is seeking a dismissal of this action with prejudice. Plaintiffs have opposed a dismissal and seek Court approval of the tentative settlement. The parties are awaiting a decision by the Court.

(B) Period Design, Inc. v. D56, Inc. ( D56 ) D56 is a subsidiary of the Company. Plaintiff alleged a breach of contract claim and sought compensatory damages of several million dollars based upon D56's alleged failure to pay royalties alleged to be due Period Design, Inc. on various products marketed and sold by D56, together with pre-judgment interest thereon. The matter was tried before the Minnesota State District Court (Hennepin County) from February 17 through February 28, 2008. On August 5, 2008, the Court issued its Findings of Fact, Conclusions of Law and Order pursuant to which the Company was ordered to pay \$205,447 in excess royalties to Period Design. The Company has adequately accrued for liabilities related to this case.

In addition to the above actions, the Company is involved in various legal proceedings, claims and governmental audits in the ordinary course of its business. The Company believes it has meritorious defenses to all proceedings, claims and audits. Management believes the impact, if any, of these legal proceedings would not be material to the results of operations, financial position or cash flows of the Company.

**Item 1A. Risk Factors**

In addition to the risk factors discussed below and other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A of the Company's 2007 Form 10-K, which could have a material impact on the Company's business, financial condition or results of operations. The risks described below and in the Company's 2007 Form 10-K are not the only risks facing the Company. Additional risks and uncertainties not presently known to the Company or that the Company currently believes to be immaterial may also adversely affect the Company's business, financial condition or results of operations.

***The delisting of the common stock of Lenox Group Inc. from the NYSE could affect its market price and tradability and reduce our ability to raise capital.***

As a result of our inability to meet an average global market capitalization standard to maintain the listing of our common stock on the NYSE, our common stock has been delisted from trading on the NYSE, effective June 1, 2008 (trading was suspended on May 16, 2008). Subsequent to the suspension of trading, the price of our stock has declined significantly. Delisting could also adversely affect our ability to raise capital, which could negatively affect our ability to pursue growth opportunities.

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***Adverse market conditions may negatively impact the results of operations, which could impact our ability to service our debt.***

The Company has a \$175,000 revolving credit facility of which \$69,927 was outstanding and \$99,000 in term debt outstanding at June 28, 2008. If we are unable to generate sufficient cash flow or otherwise obtain funds necessary to make required payments on the credit facility or if we otherwise violate the financial covenants contained in those facilities, we will be in default, unless we are able to obtain waivers of these defaults from our lenders.

Due in part to the negative impact of current economic and retail market conditions, the Company does not expect to remain in compliance with its financial covenants at the end of the third quarter of 2008. The Company's ability to continue with its current capital and operating structure and to fund operations would be contingent upon the Company's ability to negotiate a waiver with its lenders and/or restructure its outstanding indebtedness. There is currently no assurance that such a waiver can be obtained or that such a restructuring can occur. However, the Company is currently pursuing certain actions to strengthen its balance sheet and reduce indebtedness, and has commenced discussions with its term loan and credit facility lenders to restructure its outstanding indebtedness.

***On July 28, 2008, the Company announced that it is pursuing certain actions to strengthen its balance sheet and reduce indebtedness and has commenced discussions with its term loan and credit facility lenders to restructure its outstanding indebtedness. If we are not able to reach agreement with our lenders, the amount of outstanding debt could materially adversely affect us in a number of ways.***

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There is no assurance that a reduction of our indebtedness can be achieved in a timely manner, either at all or on terms that will be satisfactory to us. If we are not able to reach agreement with our lenders, the amount of our outstanding debt could materially adversely affect us in a number of ways, including:

limiting our ability to obtain any necessary financing in the future for working capital, capital expenditures, debt service requirements, or other purposes;

limiting our flexibility in planning for, or reacting to, changes in our business;

placing us at a disadvantage relative to our competitors who have lower levels of debt;

making us more vulnerable to a downturn in our business or the economy generally; and

requiring us to use a substantial portion of our cash to pay principal and interest on our debt, instead of investing those funds in the business.

*If we are able to reduce our outstanding indebtedness through negotiation with our lenders, such a reduction could result in substantial dilution of our stockholders' existing ownership.*

While there is no assurance that we will be able to restructure our outstanding indebtedness to reduce amounts outstanding on terms satisfactory to us, if we are able to do so, it is possible that such a restructuring could result in our existing holders of our common stock being substantially diluted.

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### Item 4. Submission of Matters to a Vote of Security Holders

The following matters were submitted to a vote of security holders during the Company's Annual Meeting of Stockholders held on May 21, 2008.

#### *Description of Matter:*

1. Election of Directors to serve until the Company's Annual Meeting of Stockholders in 2009:

**Director**

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|                    | Votes Cast<br>For | Authority<br>Withheld |
|--------------------|-------------------|-----------------------|
| James E. Bloom     | 6,063,769         | 3,269,434             |
| Glenda B. Glover   | 6,064,151         | 3,269,052             |
| Charles N. Hayssen | 6,066,119         | 3,267,084             |
| Stewart M. Kasen   | 6,056,569         | 3,276,634             |
| Reatha Clark King  | 6,060,671         | 3,272,532             |
| Dolores A. Kunda   | 6,053,371         | 3,279,832             |
| John Vincent Weber | 6,059,119         | 3,274,084             |

2. Ratification of Deloitte & Touche LLP as independent registered public accounting firm.

| For       | Against | Abstain | Broker Non-Votes |
|-----------|---------|---------|------------------|
| 9,246,301 | 20,782  | 66,120  | 0                |

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## Item 6. Exhibits

- 3.1 Restated Certificate of Incorporation of the Company. (Incorporated herein by reference to Exhibit 3.1 of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2005. SEC File No. 1-11908.)
- 3.2 Certificate of Designations of Series A Junior Participating Preferred Stock (Incorporated herein by reference to Exhibit A of Exhibit 4.1 of the Company's Current Report on Form 8-K, filed January 14, 2008, SEC File No. 1-11908)
- 3.3 Restated By-Laws of the Company. (Incorporated herein by reference to Exhibit 3.3 of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2005. SEC File No. 1-11908).
- 4.1 Specimen Form of Company's Common Stock Certificate (Incorporated herein by reference to Exhibit 4.1 of the Company's Annual Report on Form 10-K for the fiscal year ended December 29, 2007, SEC File No. 1-11908).
- 4.2 Rights Agreement, dated as of January 14, 2008 between Lenox Group Inc. and Wells Fargo Bank, National Association, as Rights Agent, including the form of Certificate of Designations of Series A Junior Participating Preferred Stock, the forms of Right Certificate, Assignment and Election to Purchase, and the Summary of Rights attached thereto as Exhibits A, B and C, respectively. (Incorporated herein by reference to Exhibit 4.1 of the Company's Current Report on Form 8-K, filed on January 14, 2008, SEC File No. 1-11908.)
- 10.1 Amendment No. 4 dated May 16, 2008, 2008 to the Consulting Agreement dated January 4, 2007, by and between the Company and Carl Marks Advisory Group LLC. (Incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K, filed on May 16, 2008, SEC File No. 1-11908).
- 10.2 Amendment No. 2 dated May 15, 2008 to the Letter Agreement dated as of November 9, 2007, by and between the Company and Fred Spivak. (Incorporated herein by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K, filed on May 16, 2008, SEC File No. 1-11908).
- 11.1 Computation of net loss per share.\*
- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.\*
- 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.\*

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32.2 Officer Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.\*

\* Filed herewith

Management contract or compensatory plan

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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.

LENOX GROUP INC.

Date: August 7, 2008

/s/ Marc L. Pfefferle  
Marc L. Pfefferle  
Chief Executive Officer  
(Principal Executive Officer)

Date: August 7, 2008

/s/ Fred Spivak  
Fred Spivak  
Chief Financial Officer  
Chief Operating Officer  
(Principal Financial Officer)

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**EXHIBIT INDEX**

| <b><u>Exhibit<br/>Number</u></b> | <b><u>Description</u></b>                                                                          |
|----------------------------------|----------------------------------------------------------------------------------------------------|
| 11.1                             | Computation of net income (loss) per share                                                         |
| 31.1                             | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2                             | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1                             | Officer Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002                    |