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

FORM 10-K

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

For The Fiscal Year Ended December 31, 2005

Commission File Number 1-08056

HANOVER DIRECT, INC.
(Exact Name of Registrant as Specified in Its Charter)

Delaware
(State or Other Jurisdiction of Incorporation or
Organization)

13-0853260
(IRS Employer Identification No.)

1500 Harbor Boulevard, Weehawken, New Jersey
(Address of Principal Executive Offices)

07086
(Zip Code)

(201) 863-7300
(Registrant's Telephone Number, Including Area Code)

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act: Common Stock, \$0.01 Par Value

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer Accelerated filer Non-accelerated filer

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 June 25, 2005, the last business day of the registrant's most recently completed second fiscal quarter, the aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant was \$6,200,166 (based on the closing price of the Common Stock on the Pink Sheets on June 25, 2005 of \$0.88 per share; shares of Common Stock owned by directors and officers of the Company are excluded from this calculation; such

exclusion does not represent a conclusion by the Company that all of such directors and officers are affiliates of the Company).

As of March 21, 2006, the registrant had 22,426,296 shares of Common Stock outstanding.

PART I

Item 1. Business

Preliminary Statement

This Annual Report on Form 10-K contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. The use of words such as “anticipates,” “estimates,” “expects,” “projects,” “intends,” “plans,” and “believes,” among others, generally identify forward-looking statements. Forward-looking statements are predictions of future trends and events and as such, there are substantial risks and uncertainties associated with forward-looking statements, many of which are beyond management’s control. Some of the more material risks and uncertainties are identified in “Item 1A. Risk Factors.” We do not intend, and disclaim any obligation, to update any forward-looking statements.

General

Hanover Direct, Inc. (collectively with its subsidiaries, referred to as the “Company,” “we” or “us” in this Form 10-K) is a direct marketer of quality, branded merchandise through a portfolio of catalogs and websites. We also manufacture comforters and pillows that we sell in several of our catalogs and our retail outlet stores and manufacture *Scandia Down* branded comforters, pillows and featherbeds that we sell through specialty retailers. In addition, we provide product fulfillment, telemarketing, information technology and e-commerce services to third party businesses involved in the direct marketing business.

On March 14, 2005, we sold all of the stock of Gump’s Corp. and Gump’s By Mail, Inc. to an unrelated third party. We have treated Gump’s as a discontinued operation for financial accounting purposes (see Notes 1 and 4 to the Consolidated Financial Statements). To provide more meaningful disclosure in this Form 10-K and to focus on our continuing operations, the results of Gump’s and other statistics related to the Gump’s business, such as year-to-year comparisons of the number of catalogs mailed and the percentage of our business conducted over the Internet, have been excluded from the disclosure contained in this Form 10-K except as otherwise indicated herein.

Our direct marketing operations consist of a portfolio of catalogs and associated websites in the home fashions, men’s and women’s apparel categories that included during 2005, *Domestications*, *The Company Store*, *Company Kids*, *Silhouettes*, *International Male* and *Undergear*. Each catalog can be accessed on the Internet individually by name. We also owned and operated the *Gump’s* retail store in San Francisco and the *Gump’s By Mail* catalog and website until their sale on March 14, 2005. In addition, we manufacture high quality pillows and comforters for sale in *The Company Store*, *Company Kids* and *Domestications* catalogs and websites, through our retail outlet stores and super-premium down comforters, pillows and featherbeds under the *Scandia Down* brand name, which we sell through third party luxury retailers in North and South America.

We also provide third party, end-to-end, fulfillment, logistics, telemarketing and information technology services to businesses formerly owned by the Company and select third party companies involved in the direct marketing business.

The Company is incorporated in Delaware and our executive offices are located at 1500 Harbor Boulevard, Weehawken, New Jersey 07086. The Company’s telephone number is (201) 863-7300.

Significant Shareholder; Going Private Proposal and Related Litigation

We have a significant shareholder, Chelsey Direct, LLC. Chelsey and its related affiliates (“Chelsey”) beneficially own approximately 69% of the Company’s issued and outstanding common stock (“Common Stock”) and approximately 76% of our Common Stock after giving effect to the exercise of all of Chelsey’s outstanding options and warrants. In addition, Chelsey holds all 564,819 shares of the Company’s Series C Participating Preferred Stock (“Series C Preferred”) which has 100 votes per share. Including the Series C Preferred and the outstanding options and warrants beneficially owned by Chelsey, Chelsey holds approximately 91% of the voting rights of the Company.

We received a proposal from Chelsey to acquire the shares of Common Stock that Chelsey does not already own for a cash purchase price of \$1.25 per share in a letter dated February 23, 2006. The letter indicates Chelsey's belief that we should become privately owned due to the financial drain imposed by remaining public as well as the limited benefits of remaining public. The letter states that Chelsey or an affiliate proposes to enter into a cash merger agreement with the Company and to commence a cash tender promptly after the execution of that agreement.

Shortly after receipt of the letter, the Board of Directors met and formed a special committee ("Special Committee") comprised of A. David Brown, Robert H. Masson and Donald Hecht, the three directors who are not Company employees or affiliated with Chelsey; Mr. Masson was appointed as the Special Committee's Chairman. The Special Committee appointed Wilmer Cutler Pickering Hale & Dorr LLP ("Wilmer Hale") as its independent counsel and engaged Houlihan Lokey Howard & Zukin ("Houlihan Lokey") as its financial advisor.

On March 1, 2006, we were served with a complaint filed in Delaware Chancery Court that named the Company, Chelsey and the Company's directors as defendants. We were served with a second complaint filed in Delaware Chancery Court on March 7, 2006 and a third complaint in Superior Court of New Jersey Chancery Division on March 3, 2006, that were substantially similar to the first complaint. In each complaint, the plaintiffs challenge Chelsey's going private proposal and allege, among other things, that the consideration to be paid in the going private proposal is unfair and grossly inadequate, that the special committee appointed by the Board of Directors of the Company cannot be expected to act independently, that Chelsey has manipulated the financial statements of the Company and its public statements in order to depress the stock price of the Company and that the proposal would freeze out the purported class members and capture the true value of the Company for Chelsey. In each complaint, plaintiffs seek class action certification, preliminary and permanent injunctive relief, rescission of the transaction if the offer is consummated and unspecified damages. The cases are in the initial pleadings phase.

Direct Commerce

General. We are a leading specialty direct marketer with a diverse portfolio of home fashions and men's and women's apparel marketed via direct mail-order catalogs, websites and retail outlets ("direct commerce"). All of these categories utilize our centralized purchasing and inventory management functions and our common systems platform and our telemarketing, fulfillment, distribution and administrative functions. We mailed approximately 174 million, 164 million and 170 million catalogs for the fiscal years ended 2005, 2004 and 2003, respectively.

To better focus on our direct marketing core competency, we sold the *Gump's* retail store located in San Francisco, California and the companion *Gump's By Mail* catalog to an unrelated third party in March 2005. Keystone Internet Services, LLC ("Keystone"), a wholly owned subsidiary of the Company, continues to provide product fulfillment and distribution services for the *Gump's By Mail* operation.

While our back-end/fulfillment functions are centralized, we operate merchandising, purchasing and catalog production separately for each of *The Company Store/Company Kids*, *Domestications*, *Silhouettes* and *International Male/Undergear* catalogs and websites. Each of our specialty catalogs targets its market by offering a focused assortment of merchandise designed to meet the needs and preferences of each catalog's customers. Through market research and ongoing testing of new products and concepts, each catalog has its own merchandise strategy, including appropriate price points, mailing plans and presentation of its products. We are continuing our development of exclusive or private label products for a number of our catalogs to further differentiate the catalog's identities.

Our catalogs range in size from approximately 48 to 108 pages with 9 to 22 editions per year depending on the seasonality and fashion content of the products offered. Each edition may be mailed several times each season with variations in format and content. The Company employs the services of outside creative agencies or has its own creative staff that is responsible for the designs, layout, copy, feel and theme of the catalogs. Generally, the initial sourcing of new merchandise for a catalog begins six to nine months before the catalog is mailed.

The Company operates commerce-enabled websites for each of its catalogs. The websites offer all of a particular catalog's merchandise and more extensive offerings than any single issue of a print catalog. Customers can request catalogs and place orders for not only website merchandise, but also from any print catalog already mailed.

The following is a description of our catalogs and product categories:

The Company Store is a home fashions catalog focused on high quality products that we manufacture and other private label and branded home furnishings. Basic bedding lines are produced at our LaCrosse, Wisconsin factory.

Exclusive designs and vibrant colors, along with a unique and sophisticated catalog presentation, gives *The Company Store* a strong identity within its market. Even as *The Company Store* website continued to grow with an increasing percentage of its revenue coming through this channel, catalogs remained the biggest catalyst for driving website orders.

Company Kids is a catalog developed from a category offered in *The Company Store* catalog and has grown over the past four years to nine exclusive *Company Kids* mailings. The unique themes and full room views, gives the *Company Kids* customer the opportunity to purchase the "entire room" including bed, bedding, storage, wall hangings, lamps and rugs.

Creative design and varied color pallets for the complete bed ensemble are developed by The Company Store's own design staff and sourced around the world. These exclusive designs and vibrant color pallets remain the signature identity for this quality oriented, better-priced catalog and position both The Company Store and Company Kids as strong competitors in the direct home textile market.

Domestications is "America's Authority in Home Fashions®." For over twenty years we have been and continue to be the value minded customer's top-of-mind choice when shopping for the latest in home furnishings. *Domestications* targets the mid-tier marketplace with the primary focus on bedding for every taste and lifestyle, featuring unique and novel ideas, affordable luxury, hard to find problem solvers, and exclusive designs found nowhere else. We also offer a wide range of fashion and seasonal products for every other room of the house and even have great ideas for the backyard.

Silhouettes is a moderate-to-better priced fashion catalog dedicated to woman's styles starting at size 12W. The catalog carries the current trends in fashion along with core classics, seasonal favorites and *Silhouettes* exclusives. *Silhouettes* carries a full range of apparel from boots to bathing suits, sleepwear to swimwear, and everything in between.

Silhouettes core strengths include exclusive designs and manufacturing sourced around the world. Utilizing key manufacturing plants allows *Silhouettes* to control costs and ensure the quality of these designs, offering the customer a product of style and value.

The *Silhouettes* catalog and website create a virtual department store, carrying something for every 12W plus-sized woman. The catalog continues to be the primary driver for website orders. In each of the past four years *Silhouettes* has enjoyed significant Internet sales growth. Improved on-site search capabilities and navigations have taken the tedium and frustration out of the search and have created a better virtual shopping experience, getting *Silhouettes* closer to its goal of being the customer's best friend.

International Male and Undergear 2005 marked a key transitional year for *International Male* and *Undergear*. The businesses have recently relocated to our New Jersey headquarters, where new management and a newly formed creative team have been charged with the ultimate goal of re-establishing the unique qualities of both brands and making them well-known to consumers. Fashion offerings have been increased and diversified, while the catalogs have been given a more modern look and feel to accurately reflect our evolving image and solidify our niche in the men's fashion and underwear business.

International Male, currently entering its thirty-first year in business, carries a full line of men's apparel, from sportswear to dress clothing, outerwear to underwear, shoes and accessories, offering contemporary fashion at prices that represent value to the consumer. By updating our selection with a more eclectic mix of current designs, as well as a greater variety of internationally recognized brand names, we have increased our appeal to new customers in our target demographic group. At the same time, we have continued to refine classic favorites and renew our core product lines to meet the demands of our more established customers.

Undergear, having celebrated its twentieth successful year, continues to be a market leader in the men's underwear catalog and Internet business, remaining true to its origins as a "handbook of men's underwear from around the world". In addition to underwear and swimwear from globally renowned resources, *Undergear* today includes more and varied offerings such as loungewear and workout wear that cross over into the true fashion/sportswear arena of *International Male*, along with skincare lines that complement our commitment to a youthful look and feel. *Undergear's* core strengths include the production of numerous exclusive styles and the continued expansion of our private label programs, recognized for their exceptional quality and value.

Scandia Down manufactures luxury European down comforters, pillows and featherbeds from our LaCrosse, Wisconsin facility and distributes these products together with proprietary branded luxury sheeting, towels and related accessories through its network of over 120 high end retailers in North and South America. *Scandia Down's* core growth strategy is focused on expanding distribution in select markets with key retailers, expanding product lines and categories, and developing sales and marketing support programs for licensed retailers. *Scandia Down* also plans to enable its website with e-commerce capabilities so orders can be accepted over the Internet directly.

Catalog Sales. Net sales, including delivery and service charges, through the Company's catalogs increased to \$218.7 million for the fiscal year ended December 31, 2005, an increase of \$4.3 million, or 2.0%, compared with the prior fiscal year. Overall circulation in fiscal year 2005 increased by 5.8%, supported by deeper inventory positions that have enabled a higher fulfillment rate for customer orders and a lower overall cancellation rate which helped grow both catalog and internet sales.

Internet Sales. Net sales, including delivery and service charges, through the Internet improved to \$141.3 million for the fiscal year ended December 31, 2005, an increase of \$27.3 million or 23.9%, over Internet sales in the prior fiscal year. For the year ended December 31, 2005, Internet sales had reached 39.3% of combined catalog and Internet net revenues compared to 34.7% for the year ended December 25, 2004. Customers can order catalogs and place orders for not only website merchandise but also for merchandise from any print catalog already mailed. The website for each catalog is prominently promoted within each catalog and on third-party websites.

We utilize on-line marketing opportunities by posting our catalog merchandise and accepting orders on third-party websites for which we are charged a commission. We also enter into affiliate marketing agreements with third-party website operators and pay for "click thrus" to our websites. We have entered into third party affiliate marketing agreements with Amazon.com, ArtSelect.com, CatalogCity, Decorative Product Source, Google, MSN, NexTag, Overture, Shopping.com, Linkshare and GiftCertificates.com.

Divestitures.

Gump's and Gump's By Mail. On March 14, 2005, we sold all of the stock of Gump's Corp. and Gump's By Mail, Inc. (collectively, "Gump's") to Gump's Holdings, LLC, an unrelated third party ("Purchaser") for \$8.9 million, including a \$0.4 million purchase price adjustment pursuant to the terms of a February 11, 2005 Stock Purchase Agreement. The Company recognized a gain of approximately \$3.6 million in its quarter ended March 26, 2005. Chelsey, as the holder of all of the Series C Preferred, consented to the application of the sales proceeds to reduce the outstanding balance of the senior secured credit facility ("Wachovia Facility") provided by Wachovia National Bank, as successor by a merger with Congress Financial Corporation ("Wachovia"), in lieu of using the available proceeds to redeem the Series C Preferred (the number of shares to be redeemed would have been based on the available sales proceeds and the then current redemption price per share of the Series C Preferred). This waiver

provided us with additional credit resources under the Wachovia Facility. Chelsey expressly retained its right to require redemption of the Series C Preferred subject to Wachovia's approval.

After the sale, we continue as the guarantor of one of the two leases for the San Francisco building where the store is located (we were released from liability on the other lease). The Purchaser is required to use its commercially reasonable efforts to secure the Company's release from the guarantee within a year of the closing. If the Purchaser cannot secure our release within a year of the closing, an affiliate of the Purchaser will either (i) transfer a percentage interest in its business so that we will own, indirectly, 5.0% interest of the Purchaser's common stock, or (ii) provide us with a \$2.5 million stand-by letter of credit or other form of compensation acceptable to the Company to reimburse us for any liabilities we incur under the guarantee until we are released from the guarantee or the lease is terminated. To date the Purchaser has not secured the Company's release from the guarantee and the Company has started negotiations with the Purchaser on an acceptable form of compensation.

We entered into a Direct Marketing Services Agreement with the Purchaser to provide telemarketing and fulfillment services for the *Gump's* catalog and direct marketing businesses for eighteen months. We have the option to extend the term for an additional eighteen months.

Membership Services

Third Party Membership Programs. We market and offer a variety of membership programs to our catalog customers through our call centers when they call to place an order. We also offer membership programs on our websites. The membership programs offer members discounts on a wide variety of goods and services. Initially, prospective members participate in a thirty-day trial period that, unless canceled, is automatically converted into a one year membership. Memberships are automatically renewed at the end of each year unless canceled by the member.

Until March 21, 2006, we marketed membership programs provided by Vertrue. After the expiration of the agreement with Vertrue, we began offering similar membership programs provided by Encore Marketing International ("Encore") under a two year agreement. The economic terms of the Encore program are more favorable to us than those under the Vertrue agreement provided our customers are as receptive to the Encore programs as they were to the Vertrue programs. There is, however, no assurance on how receptive our customers will be to these new programs.

Buyers' Club. Customers may purchase memberships in a number of our catalogs' Buyers' Club programs for an annual fee. The Buyers' Clubs offer members merchandise discounts or free delivery and service charge, advance notice of sales and other benefits. We use Buyers' Club programs to promote catalog loyalty, repeat business and to increase sales.

Collectively, we reported revenues from membership services of \$14.3 million, or 3.5% of net revenues, \$10.3 million or 2.8% of net revenues, and \$9.3 million or 2.5% of net revenues for fiscal years 2005, 2004 and 2003, respectively. We continue to consider opportunities to offer new and different goods and services to our customers on inbound order calls and on our websites.

Marketing and Database Management. We maintain a proprietary customer list currently containing approximately 5.4 million names of customers who have purchased from one of our catalogs or websites within the past thirty-six months. Approximately 2.4 million of the names on the list represent customers who have made purchases from at least one of our catalogs within the last twelve months. We also maintain a proprietary list of e-mail addresses totaling approximately 2.9 million addresses. We consider our customer lists one of our most valuable assets.

We utilize modeling and segmentation analysis to devise catalog marketing and circulation strategies that are intended to maximize customer contribution by catalog. This analysis is the basis used to determine which of our catalogs will be mailed and how frequently to a particular customer, as well as the promotional incentive content of the catalog(s) that a customer receives.

We utilize name lists rented from other mailers and compilers as a primary source of new customers for our catalogs. Many of our catalogs participate in a consortium database of catalog buyers whereby new customers are obtained by the periodic submission of desired customer buying behavior and interests to the consortium and the subsequent rental of non-duplicative names from the consortium. Other sources of new customers include traditional print space advertisements and promotional inserts in outbound merchandise packages.

On the Internet, our main sources of new customers are from our catalogs, through affiliate marketing arrangements, search engines, and a variety of contractual Internet affiliate marketing arrangements.

Purchasing. Our large sales volume permits us to achieve a variety of purchasing efficiencies, including the ability to obtain prices and terms that are more favorable than those available to smaller companies or than would be available to our individual catalogs were they to operate independently. We use major goods and services that are purchased or leased from selected suppliers by our central buying staff. These goods and services include paper, catalog printing and printing related services such as order forms and color separations, communication systems including telephone time and switching devices, packaging materials, expedited delivery services, computers and associated network software and hardware.

We contract for our telemarketing phone service costs (both inbound and outbound calls) under multi-year agreements. In February 2004, we entered into a twenty-six month call center service agreement with AT&T Corp. that included a one year renewal option that we exercised.

We generally enter into annual arrangements for paper and printing services with a limited number of suppliers. These arrangements permit periodic price increases or decreases based on prevailing market conditions, changes in supplier costs and continuous productivity improvements. For 2005, paper costs approximated 5.6% of the Company's net revenues. The Company experienced increases in paper prices during 2005 due to continuing tight market conditions. The Company normally experiences increased costs of sales and operating expenses as a result of the general rate of inflation and commodity price fluctuations. In the past, we have been able to mitigate, in part, the impact of these cost increases either by reducing other expenses or by raising our prices. In addition higher paper, postage and shipping costs is putting pressure on maintaining operating margins. Due to our competitive environment, we may not be able to sufficiently reduce our costs or raise prices in the future and in that event, our margins will be adversely affected.

Inventory Management. Our inventory management strategy is designed to maintain inventory levels that provide optimum in-stock positions while maximizing inventory turnover rates and minimizing the amount of unsold merchandise at the end of each season. We manage inventory levels by monitoring sales and fashion trends, making purchasing adjustments as necessary and by promotional sales. Additionally, we sell excess inventory through special sale catalogs, sales/liquidation postings in catalog websites, e-auctions, our outlet stores, off-price merchants and jobbers.

We acquire products for resale in our catalogs from numerous domestic and foreign vendors. Over recent years, the Company has trended more towards obtaining goods from foreign as opposed to domestic vendors. No single third party source supplied more than 10% of our products in 2005. Our vendors are selected based on their ability to reliably meet our production and quality requirements, as well as their financial strength and willingness to meet our needs on an ongoing basis.

At the end of fiscal 2005, we had received approximately \$5.6 million in combined catalog and Internet orders that had not been shipped and were not included in the net revenues of the Company. This amount was an increase of \$1.6 million compared with the approximately \$4.0 million of unshipped orders existing at the end of fiscal 2004. These amounts consisted mainly of backorders, orders awaiting credit card authorization, open dropship orders and orders physically in the warehouse awaiting shipment to customers. The Company fulfilled substantially all of these orders within the first seventy-five days of 2006.

Because we import a large portion of our merchandise, we have, in the past, been subject to delays in merchandise availability and shipments due to customs, quotas, duties, inspections and other governmental regulation of international trade. We continue to monitor development in this area in an effort to minimize delays in international merchandise shipments that adversely impact our business.

Telemarketing and Distribution. During 2005, we received approximately 53% of our orders through our toll-free telephone service (including our third party Business-to-Business processing) as compared with 58% in 2004. As the migration to the Internet continues to increase, we expect to see the trend of decreased percentages of toll-free telephone orders continue. Customers can access our call centers seven days per week, twenty-four hours per day. In addition, we answered more than 6.4 million customer order/service calls and processed and shipped 7.3 million packages to customers during 2005 (including our third party Business-to-Business processing).

We mail our catalogs through the United States Postal Service (“USPS”) utilizing pre-sort, bulk mail and other discounts. In 2005 we shipped 91.8% of our packages through the USPS. Overall, catalog mailing and package-shipping costs approximated 21.4% of our net revenues in 2005 as compared with 20.4% in 2004. There were no USPS rate increases during 2005, however, there was a 5% postal rate increase that took effect on January 8, 2006. The Company was negatively impacted by fuel surcharges from consolidators in 2005 as well as a higher number of third party shipments which are billed out on a cost plus a low markup basis. On October 17, 2005 we entered into a three year agreement with Federal Express that affords us reduced rates for ground shipments. We continue to examine alternative shipping services with competitive rate structures from time to time.

Order Processing and Product Fulfillment

Telemarketing. The Company operates telemarketing facilities in Hanover, Pennsylvania, York, Pennsylvania and LaCrosse, Wisconsin. Our telemarketing facilities utilize telephone switching equipment that enables us to route calls between telemarketing centers, balancing loads and providing prompt customer service.

We train our telemarketing service representatives to be courteous, efficient and knowledgeable about our products and those of our third party customers. Telemarketing service representatives generally receive forty hours of training in selling products, services, systems and communication skills through simulated as well as actual phone calls. A substantial portion of the evaluation of telemarketing service representatives’ performance is based on how well the representative meets customer service standards. While primarily trained with product knowledge to serve customers of one or more specific catalogs, telemarketing service representatives also receive cross training that enables them to take overflow calls from other catalogs. We utilize customer surveys as an important measure of customer satisfaction.

Distribution. We currently operate a distribution center in Roanoke, Virginia that services all of our catalogs and websites as well as select third party clients. Until June 2005, we also operated a smaller distribution center and storage facility in LaCrosse, Wisconsin that handled the *The Company Store* and *Company Kids*. The LaCrosse fulfillment center and the storage facility were closed in June 2005 and August 2005 when their leases expired because of capacity constraints at our LaCrosse facility and lower shipping costs available from the Roanoke facility. However since our consolidation into the Roanoke facility, we have experienced lower productivity and high employee turnover due, in part, to a tight labor market in Roanoke, increases in our own volumes and those of our third party business, that has resulted in higher costs being incurred in the fulfillment center. We currently lease 379,800 square feet at a nearby facility in Salem, Virginia for additional storage under a lease that expires on September 30, 2007. We have an option to extend the lease for three additional terms of six months each. See “Properties.”

Management Information Systems. All of our catalogs are part of our integrated mail order and catalog system operating on mid-range computer systems. Additionally, our fulfillment centers are part of our warehouse management system. These systems have been designed to meet our requirements as a high volume publisher of multiple catalogs and provider of back-end fulfillment services. We continue to devote resources to improving our systems.

Our software system is an on-line, real-time system, which is used in managing all phases of our operations and includes order processing, fulfillment, inventory management, list management and reporting. The software provides us with a flexible system that offers data manipulation and in-depth reporting capabilities. The management information systems are designed to permit us to achieve efficiencies in the way our financial, merchandising, inventory, telemarketing, fulfillment and accounting functions are performed.

Business-to-Business Services. In 1998 we began offering product fulfillment services to other direct marketers. We later expanded our service offerings to include e-commerce solutions. Currently we do not actively market these services, however, we do provide them to the purchasers of *Improvements* and *Gump's By Mail* as part of those purchase transactions and to select other direct marketers, including *National Geographic*. We extended our agreement with *Improvements* originally set to expire in June 2006 for an additional 14 months. While the primary mission of our order processing and product fulfillment services is to support our catalogs, our third party services business allows us to defray a portion of our fixed expenses. Revenues recorded from the Company's B-to-B services were \$32.9 million, or 8.1% of net revenue, \$20.8 million, or 5.8% of net revenues and \$20.0 million, or 5.4% of net revenues, for 2005, 2004 and 2003, respectively. Our product fulfillment services are provided, in large part, on a cost plus basis that has low margins.

Private Label Credit Cards

We entered into a seven year co-brand and private label credit card agreement with World Financial Network National Bank ("WFNNB") on February 22, 2005 which was amended on March 30, 2005, under which WFNNB agreed to issue private label and co-brand (Visa and MasterCard) credit cards to our catalog and website customers. We began a phased roll out of our private label credit card program in April 2005 across our catalogs and websites initially offering pre-approved credit to our core customers. In general the program extends credit to our customers at no credit risk to the Company. WFNNB provides a marketing fund to support our promotion of the program.

Restatement of Prior Financial Information and Related Matters; Delisting

In response to the discovery during the second half of 2004 of errors in our accounting treatment of certain items, we determined in the third quarter of 2004 that we needed to restate our previously filed financial statements ("Restatement"). Note 2 to the Financial Statements contains a description of the Restatement items. Shortly thereafter the Audit Committee of the Board of Directors launched an independent investigation relating to the Restatement and other accounting-related matters and engaged Wilmer Hale to conduct the investigation. As a result of the Restatement, we were unable to timely file our periodic reports with the SEC which led to the suspension of trading and ultimately the delisting of our Common Stock from the American Stock Exchange ("AMEX") on February 16, 2005. In addition, the Company was notified in January 2005 by the SEC that it was conducting an informal inquiry into the Company's financial results and financial reporting since 1998. At this point in time, the SEC informal inquiry is ongoing.

On October 20, 2005, the Audit Committee dismissed KPMG LLP ("KPMG") as our independent auditors and thereafter engaged Goldstein Golub Kessler LLP ("GGK"). GGK completed its audit of our 2004, 2003 and 2002 fiscal year end financial statements and its review of our quarterly financial statements for the third fiscal quarter of 2004 and the first three quarters of 2005 on February 8, 2006. On February 21, 2006, we filed our past due periodic reports with the SEC.

Financing

Our business is dependent on having adequate financial resources to fund our operations, catalog circulation and maintain appropriate inventory levels to meet customer demands. As described more fully in Note 7, Debt, to the consolidated financial statements, we have two credit facilities: the Wachovia Facility and the Chelsey Facility provided by Chelsey Finance. The Wachovia Facility includes a revolving credit facility with a maximum loan amount of \$34.5 million and a \$5.0 million term loan. The Wachovia Facility expires on July 8, 2007 and bears interest at 0.5% over the Wachovia prime rate. The interest rate on December 31, 2005 was 7.5%.

The Chelsey Facility is a \$20.0 million junior secured credit facility and has a three-year term. At December 31, 2005, the amount recorded as debt relating to the Chelsey Facility on the Consolidated Balance Sheet is \$11.5 million, net of the remaining, un-accreted debt discount of \$8.5 million. The Chelsey Facility bears interest at 5.0% over the Wachovia prime rate. The stated interest rate on December 31, 2005 was 12.0%. As of December 31, 2005, the annual effective interest rate of this debt instrument is approximately 57.1%, inclusive of the accretion of the debt discount arising from the issuance of common stock warrants to Chelsey Finance in connection with the Chelsey Facility. See Note 7 to the consolidated financial statements for more information regarding the Chelsey Facility and the common stock warrant.

Total recorded borrowings as of December 31, 2005, including financing under capital lease obligations, aggregated \$22.6 million, of which \$12.5 million is classified as long term, excluding the Series C Preferred of \$72.7 million, as reflected on the Company's Consolidated Balance Sheet, and the remaining, un-accreted debt discount on the Chelsey Facility of \$8.5 million. Remaining availability under the Wachovia Facility as of December 31, 2005 was \$13.8 million. We believe that we have adequate capital resources to continue to operate our business for at least the next twelve months.

Preferred Stock

Chelsey holds all 564,819 outstanding shares of Series C Preferred, the only series of preferred stock currently outstanding. See Note 8 to the consolidated financial statements for a more complete description of the Series C Preferred. In general, the Series C Preferred holders are entitled to one hundred votes per share on any matter on which the Common Stock votes. If the Company liquidates, dissolves or is wound up, the holders of the Series C Preferred are entitled to a liquidation preference of \$100 per share, or an aggregate of approximately \$56.5 million based on the shares of Series C Preferred currently owned by Chelsey, plus all accrued and unpaid dividends on the Series C Preferred. Commencing January 1, 2006, dividends will be payable quarterly on the Series C Preferred at the rate of 6.0% per annum, but such dividends may be accrued at the Company's option at a rate 1.0% higher than the applicable cash dividend rate. Effective October 1, 2008 and assuming the Company has elected to accrue all dividends from January 1, 2006 through such date, the maximum aggregate amount of the liquidation preference plus accrued and unpaid dividends on the Series C Preferred will be approximately \$72.7 million.

The Series C Preferred is mandatorily redeemable on January 1, 2009. The Company is also obligated to redeem the maximum number of shares of Series C Preferred as possible with the net proceeds of certain asset and equity sales not required to be used to repay the Wachovia Facility. Subject to Wachovia's consent, the proceeds from the sale of Gump's would have required redemption of some of the Series C Preferred. At the Company's request, Chelsey agreed to permit the Company to apply the Gump's sales proceeds to reduce the revolving credit facility under the Wachovia Facility. Chelsey expressly retained its right to require redemption of approximately \$6.9 million (the Gump's sales proceeds available for redemption) of the Series C Preferred subject to Wachovia's approval.

Employees

As of December 31, 2005, we employed approximately 2,050 full-time employees and approximately 300 part-time employees. The number of part-time employees at December 31, 2005 reflects a temporary increase in headcount necessary to fill the increase in orders during the holiday season. One of our subsidiaries has approximately 72 employees who are represented by The Union of Needletrades, Industrial and Textile Employees (UNITE!). We entered into a new union agreement on February 25, 2006 which expires on April 25, 2009.

We believe our relations with our employees are good.

Seasonality

Our business is subject to moderate variations in demand. Historically, a larger portion of our revenues have been realized during the fourth quarter compared to each of the first three quarters of the year. The percentage of annual revenues for the first, second, third and fourth quarters recognized by the Company were as follows: 2005- 22.0%, 24.6%, 23.7% and 29.7%, 2004 — 22.6%, 24.3%, 23.7% and 29.4%; and 2003 — 23.8%, 26.0%, 23.7% and 26.5%.

Competition

We believe that the principal bases upon which we compete in our direct commerce business are quality, value, service, proprietary product offerings, catalog design, website design, convenience, speed and efficiency. Our catalogs compete with other mail order catalogs, both specialty and general catalogs and bricks and mortar stores. Competitors in each of our catalog specialty areas of home fashions, women's apparel, and men's apparel include Linen Source, Pottery Barn and BrylaneHome in the home fashions, Lane Bryant, Roaman's, Jessica London and Spiegel in the women's apparel category and J. Crew, Blair and Bachrach, in the men's apparel category. Our

catalogs also compete with bricks and mortar department stores, specialty stores and discount stores including JC Penney, Wal-Mart, Target, Bed, Bath & Beyond, Bloomingdale's and Pottery Barn. Many of our competitors have substantially greater financial, distribution and marketing resources than we do.

We maintain an active e-commerce enabled Internet website presence for all of our catalogs. A substantial number of each of our catalogs' competitors maintain active e-commerce enabled Internet website presences as well. A number of these competitors have substantially greater financial, distribution and marketing resources than we do. In addition, we have entered into third party website affiliate marketing arrangements, including one with Amazon.com, as described above under "Direct Commerce — Internet Sales." We believe the Internet and online commerce will continue to be an ever increasing portion of our business and we plan to continue to explore additional marketing opportunities in this medium.

Trademarks

Each of our catalogs has its own federally registered trademarks that we own. We also own numerous trademarks, copyrights and service marks on logos, products and catalog offerings. We have also protected various trademarks internationally. We believe our trademarks, copyrights, service marks and other intellectual property are valuable assets and we continue to vigorously protect these marks.

Government Regulation

The Company is subject to Federal Trade Commission regulations governing its advertising and trade practices, Consumer Product Safety Commission regulations governing the safety of the products it sells and other regulations relating to the sale of merchandise to its customers. We are also subject to the Department of Treasury — Customs regulations with respect to any goods we directly import.

The imposition of a sales and use tax collection obligation on out-of-state catalog companies in states to which they ship products was the subject of a case decided in 1994 by the United States Supreme Court. While the Court reaffirmed an earlier decision that allowed direct marketers to make sales into states where they do not have a physical presence without collecting sales taxes with respect to such sales, the Court further noted that Congress has the power to change this law. We believe that we collect sales tax in all jurisdictions where we are currently required to do so.

Listing Information

Current trading information about the Common Stock can be obtained from the Pink Sheets (www.pinksheets.com) under the trading symbol HNVD.PK. The Common Stock had been listed on the AMEX. Because of the Restatement, we could not file our Form 10-Q for the fiscal quarter ended September 25, 2004, a condition of continued AMEX listing. Trading in our Common Stock on the AMEX was halted on November 16, 2004, formally suspended on February 2, 2005 and delisted effective February 16, 2005.

Website Access to Information

Our corporate Internet address is www.hanoverdirect.com. Our catalogs operate the following websites:

- www.thecompanystore.com
- www.companykids.com
- www.domestications.com
- www.silhouettes.com
- www.internationalmale.com
- www.undergear.com

The website for Keystone Internet Services, LLC ("Keystone") which provides business to business services is www.keystoneinternet.com and Scandia Down's is www.scandiadown.com.

We make available free of charge on or through our corporate website our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports and press releases as soon as reasonably practicable after these filings are electronically filed with or furnished to the Securities and Exchange Commission or in the case of press releases, released to the wire services. We will continue to provide electronic or paper copies of our filings free of charge upon request.

Item 1A. Risk Factors

Factors That May Affect Future Results.

There are many risks and uncertainties relating to our business; we have described some of the more important ones below. Additional risks and uncertainties not currently known to us or that we currently do not deem material may also become important factors that may harm our business. The success of our business could be impacted by any of these risks and uncertainties.

We have a majority shareholder who controls the Board and is also a secured lender and has filed a proposal to take the Company private.

Chelsey, together with its affiliates, owns approximately 69% of the Company's issued and outstanding Common Stock (including the January 10, 2005 purchase of 3,799,735 shares) and controls approximately 91% of the voting power (after giving effect to the exercise of all outstanding options and warrants to purchase Common Stock beneficially owned by Chelsey and the Series C Preferred voting rights). Chelsey has appointed a majority of our Board of Directors including our Chairman, and Chelsey Finance is the Company's junior secured lender. Recently, Chelsey offered to purchase the remaining Common Stock that it did not already own and take the Company private. As a result of Chelsey's proposal, the Company, Chelsey and the Board members were sued in both Delaware Chancery Court and Superior Court of New Jersey Chancery Division.

It should also be noted that Chelsey has sufficient voting power to approve extraordinary transactions such as a sale of the Company or its assets or a going private transaction without the vote of the other Company's shareholders. In certain transactions, these shareholders would have statutory appraisal rights under the Delaware General Corporation Law. The Board of Directors has delegated to a special committee, consisting of independent directors of the Board, the authority to review, consider and negotiate the Chelsey proposal, including the authority to reject the proposal if it determines that it cannot favorably recommend the proposal to the Board.

We have experienced several years of operating losses.

We had a history of losses prior to the 2004 fiscal year. As of December 31, 2005, our accumulated deficit was \$486.7 million. We may not be able to sustain or increase profitability on an annual basis in the future. If we are unable to maintain and increase profitability our financial condition could be adversely affected.

We are dependent on having sufficient financing to meet our requirements.

Our business is dependent upon our access to adequate financing from our senior lender, Wachovia and our junior lender, Chelsey Finance, so that we can support normal operations, purchase inventory, and secure letters of credit and other financial accommodations required to operate our business. Our credit facilities contain financial and other covenants and we have not been in compliance with these covenants at all times. In the past Wachovia and Chelsey Finance have granted us waivers and agreed to amendments to the Wachovia and Chelsey Facilities, though there can be no assurances that they will continue to do so. Our ability to borrow is also limited by the value of our inventory which is reappraised from time to time. Were either Wachovia or Chelsey Finance to deny or curtail the Company's access to capital, our business would be adversely affected. Both lenders have liens on our assets and were we to default, they could commence foreclosing on our assets.

We are also dependent on our vendors or suppliers providing us with trade credit. If certain trade creditors were to deny us credit or convert the Company to a cash basis or otherwise change credit terms, or require the Company to provide letters of credit or cash deposits to support its purchase of inventory, paper, printing and other items essential to its business, our costs would be increased and we might have inadequate liquidity to operate our business or operate profitably.

The Restatement, the delay in filing financial statements and the commencement of an informal SEC inquiry have adversely affected us and may continue to do so in the future.

We have restated our financial results as a result of various errors identified in 2004. This had led to our inability to file financial information for several quarters on a timely basis, the commencement of an investigation by the Audit Committee of the Board of Directors, the delisting of our Common Stock from the AMEX and the commencement of an informal SEC inquiry. Our former independent auditors, KPMG, were dismissed after they informed us that they needed to perform additional audit procedures on our prior period financial statements, after having audited our financial statements for over nine months. Prior to their dismissal KPMG had identified material weaknesses in our internal controls. We engaged new auditors which further delayed the filing of our financial statements. As a consequence of the foregoing, our business has been adversely affected as a result of the increased professional expenses, the diversion of senior management's attention to resolving these matters and the damage to our Company's reputation. There can be no assurances that the consequences of these events will not continue to adversely affect our business for the foreseeable future.

The SEC inquiry is ongoing and we cannot predict the outcome at this time. Were the SEC to convert the informal inquiry into a formal investigation, we would likely incur significant professional fees in addressing such investigation, and our relationships with our lenders, vendors, customers and other third parties could be adversely affected. Should the SEC find wrongdoing on our part, we may be subject to a censure or penalty that could adversely affect our results of operations, our relationships with our lenders, vendors, customers and other third parties, our reputation and our business in general.

There is limited liquidity in our shares of Common Stock.

The AMEX halted trading in our Common Stock during the fourth quarter of 2004 and delisted it on February 16, 2005. Current trading information about our Common Stock is available on the Pink Sheets. There is very little liquidity in our Common Stock at this point in time which adversely affects its price. There can be no assurances that an active market in our Common Stock will develop at any time in the foreseeable future. In addition, recently Chelsey offered to purchase the remaining Common Stock that it did not already own and take the Company private.

In light of the material weaknesses in our internal controls identified by our prior auditors there can be no assurance that other material weaknesses will not develop or be discovered in the future.

In connection with its audit of the Company's consolidated financial statements for the year ended December 25, 2004, material weaknesses in internal control over financial reporting and other matters relating to the Company's internal controls were identified by our former auditors KPMG. Although our current auditors have not brought to our attention any material weaknesses, there can be no assurance that additional weaknesses will not develop or be discovered in the future.

Our success depends on our ability to publish the optimal number of catalogs to the correct target customer with merchandise that our target customers will purchase.

Historically our catalogs have been the primary drivers of our sales. We must create, design, publish and distribute catalogs that offer and display merchandise that our customers want to purchase at prices that are attractive. Our future success depends on our ability to anticipate, assess and react to the changing demands of the customer-base of our catalogs and to design and publish catalogs that appeal to our customers. If we fail to anticipate fashion trends, select the right merchandise assortment, maintain appropriate inventory levels and creatively present merchandise in a way that is appealing to our customer-base on a consistent basis, our sales could decline significantly. We must also accurately determine the optimal number of issues to publish for each catalog and the contents thereof and the optimal circulation for each of our catalogs to maximize sales at an appropriate cost level to achieve profitability while growing our customer base. Correctly determining the universe of catalog recipients also directly impacts our results. We can provide no assurance that we will be able to identify and offer merchandise that appeals to our customer-base or that the introduction of new merchandise categories will be successful or profitable or that we will mail the optimal number of catalogs to the appropriate target customer base.

Our catalogs are in highly competitive markets.

Our catalogs are in a highly competitive markets. Many of our competitors are considerably larger and have substantially greater financial, marketing and other resources, and we can provide no assurance that we will be able to compete successfully with them in the future.

We must effectively manage our inventories and control our product fulfillment costs.

We must manage our inventories to track customer preferences and demand. We order merchandise based on our best projection of consumer tastes and anticipated demand in the future, but we cannot guarantee that our projections of consumer tastes and the demand for our merchandise will be accurate. It is critical to our success that we stock our product offerings in appropriate quantities. If demand for one or more products outstrips our available supply, we may have large backorders and cancellations and lose sales. On the other hand, if one or more products do not achieve projected sales levels, we may have surplus or un-saleable inventory that would force us to take significant inventory markdowns, which could reduce our net sales and gross margins.

We must also effectively manage our product fulfillment and distribution costs. During 2005, we consolidated our La Crosse distribution facility into our Roanoke facility because of capacity constraints at our LaCrosse facility and lower shipping costs available from the Roanoke facility. However since our consolidation into the Roanoke facility, we have experienced lower productivity and high employee turnover due, in part, to a tight labor market in Roanoke, increases in our own volumes and those of our 3rd party business, that has negatively impacted fulfillment costs and the Company's overall performance. There can be no assurances that this trend will not continue.

We have experienced rising costs in paper, shipping and other expense items which has put pressure on our operating margins. Because of the competitive environment in which our catalogs compete, there can be no assurances that we will be able to lower our costs or increase our prices sufficient to cover our increased costs of doing business.

We may have difficulty sourcing our products, especially those sourced overseas.

Most of our products are manufactured by third-party suppliers. Some of these products are manufactured exclusively for us using our designs. If any of these manufacturers were to stop supplying us with merchandise or go out of business, it would take several weeks to secure a new manufacturer and there could be a disruption in our supply of merchandise. If we are unable to provide our customers with continued access to popular merchandise manufactured exclusively for us, our operating results could be harmed.

We also source many of our products overseas. While products sourced overseas typically have lower costs, our product margins may be slightly offset by an increase in inbound freight costs. As security measures around shipping ports increase, these additional costs may result in higher inbound freight costs. As we increase our overseas sourcing, we face the risk of these delays which could harm our business and results of operations. We cannot predict whether any of the countries in which our merchandise currently is manufactured or may be manufactured in the future will be subject to additional trade restrictions imposed by the U.S. and other foreign governments, including the likelihood, type or effect of any such restrictions. Trade restrictions, including increased tariffs or quotas, embargoes, and customs restrictions, against items that we offer or intend to offer to our customers, as well as U.S. or foreign labor strikes, work stoppages or boycotts, could increase the cost or reduce the supply of items available to us and adversely affect our business, financial condition and results of operations. Our sourcing operations also may be adversely affected by political and financial instability resulting in the disruption of trade from exporting countries, significant fluctuation in the value of the U.S. dollar against foreign currencies, restrictions on the transfer of funds and/or other trade disruptions. Any disruption or delays in, or increased costs of, importing our products could have an adverse effect on our business, financial condition and operating results.

Our success is dependent on the performance of our vendors and service providers.

Our business depends on the performance of third parties, including merchandise manufacturers and foreign buying agents, telecommunications service providers, the USPS, shipping companies, printers, professionals, photographers, creative designers and models, credit card processing companies and the service bureau that maintains our customer database.

Any interruptions or delays in the provision of these goods and services could materially and adversely affect our business and financial condition. Although we believe that, in general, the goods and services we obtain from third parties could be purchased from other sources, identifying and obtaining substitute goods and services could result in delays and increased costs. If any significant merchandise vendor or buying agent were to suddenly discontinue its relationship with us, we could experience temporary delivery delays until a substitute supplier could be found.

Our business is subject to a number of external costs that we are unable to control.

Our business is subject to a number of external costs that we are unable to control, including labor costs, insurance costs, printing, paper and postage expenses, shipping charges associated with distributing merchandise to our customers and inventory acquisition costs, including product costs, quota and customs charges. In particular, the paper market is extremely tight at this time and we had experienced increased costs for our paper needs for 2005. We also ship a majority of our merchandise by USPS and have experienced increases in postal rates in 2006 as well as fuel surcharges from consolidators in 2005. Increases in these or other external costs could adversely affect our financial position, results of operations and cash flows unless we are able to pass these increased costs along to our customers.

Our management team is critical to our success.

Our success depends to a significant extent upon our ability to attract and retain key personnel. Moreover, five members of our senior management team, the CEO, the CFO, the General Counsel and the presidents of two of our catalogs, have each been with the Company for less than two years. Our current employment agreements with our CEO and CFO each expire in May 2006. Our success is dependent on the ability of our senior management to successfully integrate into and manage our business and the individual catalogs. The loss of the services of one or more of our current members of senior management, or our failure to attract talented new employees, could have a material adverse effect on our business.

We are dependent on the continued growth of Internet sales.

We derive an increasing portion of our revenue from our websites. While we continue to believe that our catalogs are the primary sales drivers of our merchandise, e-commerce is an important part of our business. Factors which could reduce the widespread use of the Internet include actual or perceived lack of privacy protection, actual or perceived lack of security of credit card information, possible disruptions or other damage to the Internet or telecommunications infrastructure, increased governmental regulation and taxation and decreased use of personal computers. Our business would be harmed by any decrease or less than anticipated growth in Internet usage.

Our Series C Preferred Stock begins to accrue dividends in 2006 and is subject to mandatory redemption in 2009.

Commencing January 1, 2006, dividends are payable quarterly on the Series C Preferred at the rate of 6.0% per annum, with the preferred dividend rate increasing by 1 1/2% per annum on each anniversary of the dividend commencement date until redeemed. At the Company's option, in lieu of cash dividends, the Company may accrue dividends that will compound at a rate 1.0% higher than the applicable cash dividend rate. The Wachovia Loan Agreement currently prohibits the payment of cash dividends. The Series C Preferred, if not redeemed earlier, must be redeemed by the Company on January 1, 2009 for the liquidation preference and all accrued and unpaid dividends. Effective October 1, 2008 and assuming the Company has elected to accrue all dividends from and after January 1, 2006, the maximum aggregate amount of the liquidation preference plus accrued and unpaid dividends on the Series C Preferred will be approximately \$72.7 million.

We have not fully assessed the effectiveness of our internal controls over financial reporting.

If we remain a public company we will need to assess the effectiveness of our internal controls over financial reporting in connection with the rules adopted by the Securities and Exchange Commission under Section 404 of the Sarbanes-Oxley Act of 2002. The SEC delayed implementation of Section 404 for companies with a market capitalization of less than \$75.0 million such as the Company. Under the current rules and the Company's current market capitalization, Section 404 would apply to our 2007 financial statements if we remain a public company. There can be no assurance that management will not identify significant deficiencies that would result in one or more material weaknesses in our internal controls over financial reporting. We cannot provide any assurance that testing of our internal controls will not uncover significant deficiencies that would result in a material weakness in our internal controls over financial reporting.

If we fail to comply in a timely manner with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 or to remedy any material weaknesses in our internal controls that we may identify, such failure could result in material misstatements in our financial statements and cause a default under the Company's credit facilities, cause investors to lose confidence in our reported financial information and have a negative effect on the trading price of our common stock.

For those material weaknesses previously identified and those that may be identified in the future, we will adopt and implement policies and procedures to remediate such material weaknesses. Designing and implementing effective internal controls is a continuous process that requires us to anticipate and react to changes in our business and the economic environment in which we operate, and to expend significant resources to maintain a system of internal controls that is adequate to satisfy our reporting obligations as a public company. We cannot assure you that the measures we will take will remediate any material weaknesses that we may identify, or that we will implement and maintain adequate controls over our financial process and reporting in the future.

Any failure to complete our assessment of our internal controls over financial reporting, to remediate any material weaknesses that we may identify, or to implement new or improved controls, could harm our operating results, cause us to fail to meet our reporting obligations, or result in material misstatements in our financial statements and cause a default under the Company's credit facilities. Any such failure also could adversely affect the results of the periodic management evaluations and, in the case of a failure to remediate any material weaknesses that we may identify, would adversely affect the annual auditor attestation reports regarding the effectiveness of our internal control over financial reporting that are required under Section 404 in 2007. Inferior internal controls could also cause investors to lose confidence in our reported financial information, which could have a negative effect on the trading price of our common stock.

We receive a material portion of our operating profits from our sale of third party membership services and derive a material portion of our revenues by providing fulfillment services to third parties.

In 2005, we received approximately \$10.7 million in revenues from our sale of Vertrue membership programs, which generates a material portion of our operating profit. Our agreement with Vertrue was replaced in March 2006 with a two year agreement with Encore. There can be no assurances that our revenues from sales of membership programs will not decrease as a result of the change to a new membership program provider. Were this revenue stream to diminish or were we to lose it entirely, our operating results would be adversely affected. In addition, our membership program revenues may be adversely affected as more of our business transitions to the Internet where customer response rates are lower than the response rates for customers who place phone orders.

We also derive a material portion of our revenues by providing order processing and product fulfillment services to third parties. These revenues offset some of our fixed costs associated with operating our distribution facility and our call centers and were we to lose this revenue stream, our results would be adversely affected unless our direct marketing operations made up for the lost revenues.

In light of these risks and uncertainties and others not mentioned above, the forward-looking statements contained in this Annual Report may not occur. Accordingly, readers should not place undue reliance on these forward-looking statements, which only reflect the views of the Company management as of the date of this report. The Company is not under any obligation and does not intend to publicly update or review any of these forward-looking statements, whether as a result of new information, future events or otherwise, even if experience or future events make it clear that any expected results expressed or implied by those forward-looking statements will not be realized.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

The Company's subsidiaries own and operate the following properties:

- A 775,000 square foot warehouse and fulfillment facility located in Roanoke, Virginia;
- A 48,000 square foot administrative and telemarketing facility located in LaCrosse, Wisconsin; and
- A 150,000 square foot home fashion manufacturing facility located in LaCrosse, Wisconsin used to manufacture comforters, pillows and featherbeds for sale under "The Company Store" and "Scandia Down" names.

Each of these properties is subject to a mortgage in favor of Wachovia and a second mortgage in favor of Chelsey Finance.

In addition, the Company or its subsidiaries lease the following properties:

- A 50,000 square foot corporate headquarters and administrative offices located in Weehawken, New Jersey under a lease expiring in June 2015. A 6,900 square foot storage facility in Secaucus, New Jersey under a lease expiring May 31, 2010;
- Two properties used as outlet stores located in Wisconsin having approximately 19,500 square feet of space in the aggregate, with leases running through February 2007. Another outlet store located in Pennsylvania was closed at the end of February 2006;
- A 117,900 square foot telemarketing, customer service and administrative facility located in Hanover, Pennsylvania, under a lease extension expiring on June 30, 2006;
- An 11,000 square foot satellite telemarketing facility in York, Pennsylvania under a lease expiring July 31, 2006;
- A 379,800 square foot warehouse and fulfillment facility located in Salem, Virginia for additional storage for the Roanoke distribution center under a lease that expires on September 30, 2007; and
- A 5,100 square foot retail outlet store facility in Roanoke, Virginia under a lease expiring in February 2009.

Item 3. Legal Proceedings

Litigation Related to Going Private Proposal:

Three substantially identical complaints have been filed against the Company, Chelsey and each of the Company's directors: the first complaint was filed in Delaware Chancery Court by Glenn Friedman and L.I.S.T., Inc. as plaintiffs on March 1, 2006; the second complaint was filed in Delaware Chancery Court by Howard Lasker as plaintiff on March 7, 2006; and the third complaint was filed in Superior Court of New Jersey Chancery Division by Feivel Gottlieb as plaintiff on March 3, 2006. In each complaint, the plaintiffs challenge Chelsey's going private proposal and allege, among other things, that the consideration to be paid in the going private proposal is unfair and grossly inadequate, that the special committee appointed by the Board of Directors of the Company cannot be expected to act independently, that Chelsey has manipulated the financial statements of the Company and its public statements in order to depress the stock price of the Company and that the proposal would freeze out the purported class members and capture the true value of the Company for Chelsey. In each complaint, plaintiffs seek class action certification, preliminary and permanent injunctive relief, rescission of the transaction if the offer is consummated and unspecified damages. The cases are in the initial pleadings phase. Based upon a preliminary analysis of the complaints, the Company believes that the complaints are without merit and intends to defend its interests vigorously.

SEC Informal Inquiry:

See Note 2 to the consolidated financial statements for a discussion of the informal inquiry being conducted by the SEC relating to the Company's financial results and financial reporting since 1998.

Class Action Lawsuits:

The Company was a party to four class action/representative lawsuits that all involved allegations that the Company's charges for insurance were invalid, unfair, deceptive and/or fraudulent. During the third quarter of 2005, the Company favorably resolved three of the cases: one was settled for an aggregate payment of \$39,500, the Company prevailed in another case which led to the plaintiff in the third case voluntarily dismissing his case. In the remaining case, Martin v. Hanover Direct, Inc., et. al., the Company prevailed in its appeal of class certification in an October 25, 2005 decision. Martin filed an Application for Rehearing and a Petition for a Writ of Certiorari in the Oklahoma Supreme Court, both of which were denied during the first quarter of 2006.

Claims for Post-Employment Benefits

The Company is involved in four lawsuits instituted by former employees arising from the Company's denial of change in control ("CIC") benefits under compensation continuation plans following the termination of employment.

Two of these cases arose from the circumstances surrounding the Restatement:

Charles Blue v. Hanover Direct, Inc., William Wachtel, Stuart Feldman, Wayne Garten and Robert Masson, (Supp. Ct. N.J., Law Div. Hudson Cty, Docket No.: L-5153-05) is an action instituted by the Company's former Chief Financial Officer who was terminated for cause on March 8, 2005. The complaint seeks compensatory and punitive damages and attorney's fees and alleges retaliation, mental anguish and reputational damage, loss of earnings and employment and racial discrimination. The Company believes that Mr. Blue was properly terminated for cause and that his claims are groundless.

Frank Lengers v. Hanover Direct, Inc., Wayne Garten, William Wachtel, A. David Brown, Stuart Feldman, Paul S. Goodman, Donald Hecht and Robert Masson, (Supp. Ct. N.J., Law Div. Hudson Cty, Docket No.: L-5795-05) was brought as a result of the Company terminating the employment of its former Vice President, Treasury Operations & Risk Management, on March 8, 2005 for cause. The complaint seeks compensatory and punitive damages and attorney's fees and alleges improper denial of CIC benefits, age and disability discrimination, handicap discrimination, aiding and abetting and breach of contract. The Company believes that Mr. Lengers was properly terminated for cause and that his claims are groundless.

The Company believes that it properly denied CIC benefits with respect to each of the four former employees and that it has meritorious defenses in all of the cases and plans a vigorous defense.

In addition, the Company is involved in various routine lawsuits of a nature that is deemed customary and incidental to its businesses. In the opinion of management, the ultimate disposition of these actions will not have a material adverse effect on the Company's financial position, results of operations, or cash flows.

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

None.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matter and Issuer Purchases of Equity Securities

Current trading information about our Common Stock can be obtained from the Pink Sheets under the trading symbol "HNVD.PK." The Common Stock was delisted from the AMEX effective February 16, 2005 as a result of the Company's inability to timely file its periodic SEC reports and its failure to comply with the AMEX's continued listing standards.

The following table sets forth, for the periods shown, the high and low sale prices of our Common Stock (as adjusted for the reverse stock split that occurred on September 22, 2004). As of March 21, 2006, we had 22,426,296 shares of Common Stock outstanding. Of these, 15,380,772 shares were held directly or indirectly by Chelsey and its affiliates. As a result, 7,045,524 shares of Common Stock were held by other public shareholders. There were approximately 540 holders of record of Common Stock as of March 23, 2006.

	<u>High</u>	<u>Low</u>
Fiscal 2005		
First Quarter (Dec. 26, 2004 to March 26, 2005)	\$ 1.44	\$ 0.70
Second Quarter (March 27, 2005 to June 25, 2005)	\$ 1.00	\$ 0.69
Third Quarter (June 26, 2005 to Sept. 24, 2005)	\$ 1.55	\$ 0.88
Fourth Quarter (Sept. 25, 2005 to Dec. 31, 2005)	\$ 1.50	\$ 0.95
 Fiscal 2004		
First Quarter (Dec. 28, 2003 to March 27, 2004)	\$ 3.00	\$ 2.00
Second Quarter (March 28, 2004 to June 26, 2004)	\$ 2.50	\$ 1.30
Third Quarter (June 27, 2004 to Sept. 25, 2004)	\$ 1.80	\$ 1.20
Fourth Quarter (Sept. 26, 2004 to Dec. 25, 2004)	\$ 1.59	\$ 1.26

The Company is restricted from paying dividends on its Common Stock or from acquiring its Common Stock by certain debt covenants contained in the loan agreements for the Wachovia Facility and the Chelsey Facility. See Note 7 to the Notes to the consolidated financial statements for additional information regarding the certain debt covenants and loan agreements.

Reverse Stock Split. At our 2004 Annual Meeting of Shareholders held on August 12, 2004, our shareholders approved a one-for-ten reverse stock split of the Common Stock, which became effective at the close of business on September 22, 2004. In this Annual Report on Form 10-K, the number of shares of Common Stock outstanding, per share amounts, stock warrants, stock option and exercise price data relating to the Company's Common Stock, for periods prior to the reverse stock split, have been restated to reflect the effect of the reverse stock split.

Equity Compensation Plan Information Table

The following table provides information about the securities authorized for issuance under the Company's equity compensation plans as of December 31, 2005:

	(a)	(b)	(c)
<u>Plan category</u>	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column(a))
Equity compensation plans approved by security holders	899,600	\$ 5.30	2,020,400
Equity compensation plans not approved by security holders	270,000	2.50	270,000
Total	1,169,600	\$ 4.65	2,290,400

The equity compensation plan not approved by security holders relates to options granted to Meridian, an affiliate of Mr. Shull who was a former Chief Executive Officer of the Company. See Note 7 of Notes to the consolidated financial statements.

Item 6. Selected Financial Data

The following table presents selected financial data for each of the fiscal years indicated:

	2005	2004	2003	2002	2001
(In thousands of dollars, except per share data)					
Income Statement Data:					
Net revenues	\$ 407,442	\$ 360,526	\$ 370,096	\$ 407,920	\$ 478,880
Special charges	(69)	1,684	215	3,678	10,617
Income (loss) from operations	17,136	7,313	(143)	(4,866)	(27,200)
Gain on sale of <i>Improvements</i>	--	--	1,911	570	23,240
Gain on sale of Kindig Lane Property	--	--	--	--	1,529
Income (loss) before interest and income taxes	17,136	7,313	1,768	(4,296)	(2,431)
Interest expense, net	8,146	5,105	11,715	5,072	6,426
Provision for income taxes	29	174	11,328	3,791	120
Net income (loss) from continuing operations	8,961	2,034	(21,275)	(13,159)	(8,977)
Gain from discontinued operations of <i>Gump's</i>	2,996	2,967	1,215	2,250	2,171
Net income (loss) and comprehensive income (loss)	11,957	5,001	(20,060)	(10,909)	(6,806)
Preferred stock dividends and accretion	--	--	7,922	15,556	10,745
Earnings Applicable to Preferred Stock	294	124	--	--	--
Net income (loss) applicable to common stockholders	<u>\$ 11,663</u>	<u>\$ 4,877</u>	<u>\$ (27,982)</u>	<u>\$ (26,465)</u>	<u>\$ (17,551)</u>
Net Income (Loss) Per Common Share:					
From continuing operations – basic	<u>\$ 0.39</u>	<u>\$ 0.09</u>	<u>\$ (2.02)</u>	<u>\$ (2.07)</u>	<u>\$ (0.93)</u>
From continuing operations – diluted	<u>\$ 0.27</u>	<u>\$ 0.07</u>	<u>\$ (2.02)</u>	<u>\$ (2.07)</u>	<u>\$ (0.93)</u>
From discontinued operations – basic	<u>\$ 0.13</u>	<u>\$ 0.13</u>	<u>\$ 0.08</u>	<u>\$ 0.16</u>	<u>\$ 0.10</u>
From discontinued operations – diluted	<u>\$ 0.09</u>	<u>\$ 0.11</u>	<u>\$ 0.08</u>	<u>\$ 0.16</u>	<u>\$ 0.10</u>
Net income (loss) – basic	<u>\$ 0.52</u>	<u>\$ 0.22</u>	<u>\$ (1.94)</u>	<u>\$ (1.91)</u>	<u>\$ (0.83)</u>
Net income (loss) - diluted	<u>\$ 0.36</u>	<u>\$ 0.18</u>	<u>\$ (1.94)</u>	<u>\$ (1.91)</u>	<u>\$ (0.83)</u>
Weighted Average Number of Shares Outstanding (in thousands):					
Basic	<u>22,426</u>	<u>22,220</u>	<u>14,439</u>	<u>13,828</u>	<u>21,054</u>
Diluted	<u>32,588</u>	<u>27,015</u>	<u>14,439</u>	<u>13,828</u>	<u>21,054</u>

	2005	2004	2003	2002	2001
(In thousands of dollars)					
Balance Sheet Data (End of Period):					
Working capital (deficit)	\$ 26,007	\$ 10,622	\$ (10,399)	\$ (6,200)	\$ 658
Total assets	122,177	130,499	116,547	145,274	161,032
Total debt, excluding Preferred Stock	22,648	27,886	22,510	25,129	29,710
Series B Participating Preferred Stock	--	--	--	92,379	76,823
Series C Participating Preferred Stock	72,689	72,689	72,689	--	--
Shareholders' deficiency	(25,548)	(37,652)	(56,339)	(63,011)	(38,119)

There were no cash dividends declared on the Common Stock in any of the periods presented.

Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations

The following table sets forth, for the fiscal years indicated, the percentage relationship to net revenues of certain items in the Company’s Consolidated Statements of Income (Loss). In addition, on March 14, 2005, we sold all of the stock of Gump’s Corp. and Gump’s By Mail, Inc. (collectively, “Gump’s”) to Gump’s Holdings, LLC. The following reflects the Gump’s operating results and gain on sale as discontinued operations.

	Fiscal Year		
	2005	2004	2003
Net revenues	100.0%	100.0%	100.0%
Cost of sales and operating expenses.....	62.1	60.2	63.1
Special charges	(0.0)	0.5	0.1
Selling expenses	25.0	25.2	24.2
General and administrative expenses.....	8.0	11.2	11.5
Depreciation and amortization.....	0.7	0.9	1.1
Gain on sale of <i>Improvements</i>	—	—	0.5
Income before interest and income taxes.....	4.2	2.0	0.5
Interest expense, net	2.0	1.4	3.2
Provision for Federal and state income taxes	0.0	0.0	3.1
Gain from discontinued operations of <i>Gump’s</i>	0.7	0.8	0.3
Net income (loss).....	2.9%	1.4%	(5.4)%

Executive Summary

In 2004 we installed a new management team and secured additional financing that alleviated the capital constraints that had previously hampered our business. In the last half of 2004, we were able to increase inventory levels to service our customer demand and begin increasing our catalog circulation. This led to increased sales and net income of nearly \$5 million. In 2004 we decided to relocate our men’s apparel catalogs to our New Jersey headquarters during the first quarter of 2005 and installed a new team. Consequently, we did not expect growth in those catalogs during the transition period. We also decided to consolidate our catalog operations into one facility located in New Jersey and consolidated our distribution function into our Roanoke Virginia distribution center because of capacity constraints at our LaCrosse facility and lower shipping costs available from the Roanoke facility.

In the first nine months of 2005 the Company experienced positive trends in both revenues and profits compared to 2004. We then experienced setbacks starting in the third quarter which resulted in lower profits in the fourth quarter.

Demand and customer response in the *The Company Store* catalog, which had been our strongest catalog for the last several years, began a downward trend late in the second fiscal quarter of 2005 that continued throughout the remainder of the year. While we have hired a new President for *The Company Store*, we expect this trend to continue for some time. *The Company Store* also suffered from higher merchandise costs and catalog expenses that also adversely affected its results. *Domestications* saw its demand increase markedly but experienced inventory problems, exacerbated in part by the larger than projected demand, which led to higher backorder levels and customer cancellations which adversely affected its results. *Silhouettes* had stronger revenues and profits throughout the year. The men’s business experienced lower revenues and profits for the year after it went through a relocation and installation of a completely new management team.

We were also adversely affected by diminished productivity in our distribution function brought on by the consolidation of our LaCrosse distribution facility into our Roanoke distribution facility. This reached a head in the fourth quarter, our busiest quarter, when high employee turnover in Roanoke and space constraints brought on by larger than expected inventory levels both in our catalogs and our third party business to business customers, led to diminished productivity. Our 2005 results were also hurt by increasing costs including paper and product shipping costs.

We ended the year with income from continuing operations of \$9.0 million and net income applicable to common shareholders of \$11.7 million on sales of \$407.4 million, all which were increases over the prior year.

Our 2005 results from continuing operations were positively impacted by a number of expense/income items outside of normal operations which provided a net benefit in 2005. As set forth in the table below, in 2004 we had a number of expense items that adversely affected our results in that year by approximately \$5.7 million. In 2005, some of these items, principally a \$4.5 million reserve we had established for post employment benefits for a former CEO, were reversed and we had a net benefit from these items which improved our 2005 results by over \$1.2 million. A summary of these expense / (income) items incurred during 2005, 2004 and 2003 are as follows (in thousands):

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Severance and Termination Costs	\$ 760	\$ 2,607	\$ 725
Special Charges	(69)	1,536	1,308
Legal and Audit Fees related to Restatement Class Action	2,559	617	--
Litigation Reserve	--	535	--
Facility Exit Costs	--	201	--
Rakesh Kaul Accrual	(4,488)	196	24
Compensation Continuation Agreement Costs	--	--	3,083
Change in Vacation and Sick Policy	--	--	(1,634)
	<u>\$ (1,238)</u>	<u>\$ 5,692</u>	<u>\$ 3,506</u>

Results of Operations

2005 Compared to 2004

Net Income (Loss). The Company reported net income applicable to common shareholders of \$11.7 million, or \$0.52 basic and \$0.36 diluted income per share, for the year ended December 31, 2005 compared to \$4.9 million, or \$0.22 basic and \$0.18 diluted income per share, in 2004. The Company reported income from continuing operations of \$9.0 million, or \$0.39 basic and \$0.27 diluted income per share, for the year ended December 31, 2005 compared to \$2.0 million, or \$0.09 basic and \$0.07 diluted income per share, in 2004.

In addition to improved operating results, the increase in net income applicable to common shareholders was primarily the result of the following:

- Improved operating results generated from a \$46.9 million increase in net revenues;
- A favorable impact of \$4.5 million from the reversal of an accrual established in fiscal 2000 due to the expiration of Rakesh Kaul's rights to pursue his claims against the Company;
- A favorable impact of \$1.8 million in expense reduction due to Special Charges incurred in 2004 due to restructuring charge; and
- A favorable impact of \$1.5 million due to the reduction in general and administrative expenses related to severance.

Partially offset by:

- An unfavorable impact of \$3.0 million on net interest expense primarily due to interest costs incurred with the \$20.0 million junior secured credit facility with Chelsey Finance (“Chelsey Facility”) which the Company closed on July 8, 2004. See Note 7 of Notes to the consolidated financial statements for additional information regarding the Chelsey Facility; and
- An unfavorable impact of \$1.9 million related to general and administrative expenses incurred for the investigation conducted by the Audit Committee of the Board of Directors in connection with the restatement of the Company’s consolidated financial statements and other accounting-related matters.

Net Revenues. Net revenues increased by approximately \$46.9 million (13.0%) for the year ended December 31, 2005 to \$407.4 million from \$360.5 million in 2004. This increase was primarily driven by an increase in catalog circulation levels and higher response rates supported by deeper inventory positions that enabled higher initial fulfillment rates for customer orders and lower overall cancellation rates. Higher demand was experienced in *The Company Store* (although on lower customer response rates), *Domestications* and *Silhouettes* catalogs, while lower demand was experienced for the *International Male* catalogs. Revenues recorded from the Company’s business to business services increased by approximately \$12.1 million for the year ended December 31, 2005 to \$32.9 million from \$20.8 million in 2004. In addition, revenue relating to our membership programs increased by approximately \$4.0 million for the year ended December 31, 2005 to \$14.3 million from \$10.3 million in 2004. Internet sales revenue comprised 39.3% of combined Internet and catalog net revenues for the year ended December 31, 2005 compared with 34.7% in 2004, and have increased by approximately \$27.3 million, or 23.9%, to \$141.3 million for the year ended December 31, 2005 from \$114.0 million in 2004.

Cost of Sales and Operating Expenses. Cost of sales and operating expenses increased by \$36.1 million to \$253.0 million for the year ended December 31, 2005 as compared with \$216.9 million in 2004. Cost of sales and operating expenses increased to 62.1% of net revenues for the year ended December 31, 2005 as compared with 60.2% of net revenues in 2004. As a percentage of net revenues, this increase was primarily due to increases in product shipping costs, merchandise and fulfillment costs. The Company has more aggressively liquidated slower moving inventory through clearance avenues within its catalogs and websites, thus resulting in lower product margins. In addition, since the consolidation of our fulfillment centers, our Roanoke fulfillment center has experienced high levels of employee turnover and lower productivity which has resulted in higher costs being incurred in the fulfillment center. This trend of high levels of employee turnover and lower productivity started in the third quarter of 2005 and continued through the end of fiscal 2005. This trend is expected to continue during 2006.

Special Charges. In December 2000, the Company began a strategic business realignment program that resulted in the recording of special charges for severance, facility exit costs and fixed asset write-offs. The actions related to this strategic business realignment program were taken in an effort to direct our resources primarily towards a loss reduction strategy and a return to profitability. On June 30, 2004, we decided to consolidate the operations of the LaCrosse, Wisconsin fulfillment center and storage facility into the Roanoke Virginia fulfillment center by June 30, 2005. The LaCrosse fulfillment center and the LaCrosse storage facility were closed in June 2005 and August 2005 upon the expiration of their leases. This plan was prompted by excess capacity at our Roanoke facility at that time and the lack of sufficient warehouse space in the leased Wisconsin facilities to support the growth of *The Company Store* and lower shipping costs available from the Roanoke facility. Since the consolidation of our fulfillment centers, our Roanoke fulfillment center has experienced high levels of employee turnover and lower productivity that has resulted in higher costs being incurred in the fulfillment center. In addition, on November 9, 2004, we decided to relocate the *International Male* and *Undergear* catalog operations to our Corporate offices in New Jersey. The relocation was effected to consolidate operations and reduce costs while leveraging our catalog expertise in New Jersey. The relocation was completed on February 28, 2005. However, since the relocation and consolidation of the Men’s apparel catalogs, the transition has negatively impacted the performance of the Men’s apparel catalogs in 2005.

Special charges decreased by \$1.8 million to (\$0.1) million for the year ended December 31, 2005 as compared

to \$1.7 million in 2004. During the year ended December 25, 2004, the Company recorded \$0.5 million and \$0.9 million in severance and related costs associated with the consolidation of the LaCrosse operations and the relocation of the *International Male* and *Undergear* catalog operations to New Jersey, respectively. In addition, we recorded an additional \$0.3 million in severance and related costs during the fourth quarter of 2004 associated with the elimination of 15 full-time company-wide positions.

Selling Expenses. Selling expenses increased by \$11.1 million to \$102.0 million for the year ended December 31, 2005 as compared with \$90.9 million in 2004. Selling expenses decreased to 25.0% of net revenues for the year ended December 31, 2005 from 25.2% in 2004. As a percentage of net revenues, this change was primarily due to higher response rates that more than offset the cost of higher catalog circulation and higher paper costs. Postal rate increases effective January 2006 and the continuation of higher paper costs is expected to continue to negatively impact results for 2006.

General and Administrative Expenses. General and administrative expenses decreased approximately \$7.8 million to \$32.6 million for the year ended December 31, 2005 from \$40.4 million in 2004. As a percentage of net revenues, general and administrative expenses decreased to 8.0% of net revenues for the year ended December 31, 2005 compared with 11.2% of net revenues in 2004. This decrease of \$7.8 million was principally due to the reversal of a \$4.5 million (1.1% of net revenues) reserve we had established for post employment benefits for a former CEO. In addition the Company incurred lower severance and termination costs partially offset by higher legal and audit fees related to the Restatement. See "Executive Summary."

Depreciation and Amortization. Depreciation and amortization decreased approximately \$0.4 million to \$2.9 million for the year ended December 31, 2005 from \$3.3 million in 2004. The decrease was primarily due to property and equipment that have become fully depreciated, partially offset by the depreciation of newly purchased property and equipment.

Income from Operations. The Company's income from operations increased by approximately \$9.8 million to \$17.1 million for the year ended December 31, 2005 from \$7.3 million in 2004.

Interest Expense, Net. Interest expense, net, increased \$3.0 million to \$8.1 million for the year ended December 31, 2005 from \$5.1 million in 2004. This increase was primarily due to \$2.3 million in higher accretion of the debt discount and \$1.3 million higher cash interest payments related to the Chelsey Facility which was partially offset by lower borrowings and interest payments under the Wachovia Facility. See Note 7 of Notes to the consolidated financial statements.

Income Taxes. The Company's income tax provision decreased by approximately \$0.2 million to \$0.0 million for the year ended December 31, 2005 as compared with \$0.2 million in 2004. The Company had a tax loss for 2005 for federal income tax purposes and in 2004 the Company had sufficient net operating loss carryovers ("NOLs") and its taxable income was below its §382 limit to eliminate its entire 2004 regular Federal income tax. The 2004 Federal income tax provision of \$0.1 million is comprised of the Federal alternative minimum tax ("AMT"). The Company has AMT net operating loss carryovers for which utilization is limited to a maximum of 90% of AMT taxable income. See Note 12 of Notes to the consolidated financial statements for further discussion of the Company's income taxes.

Gain from discontinued operations of Gump's. On March 14, 2005, the Company sold all of the stock of Gump's to Gump's Holdings, LLC. The Company recognized a gain of \$3.0 million for the year ended December 31, 2005 which represents a \$3.6 million gain on the sale of Gump's net of a \$0.6 million loss from Gump's operation's for the period December 26, 2004 through March 14, 2005. The Company recognized a gain of \$3.0 million for the year ended December 25, 2004 which represents Gump's ongoing operations.

2004 Compared with 2003

Net Income (Loss). The Company reported net income applicable to common shareholders of \$4.9 million, or \$0.22 basic and \$0.18 diluted income per share, for the year ended December 25, 2004 compared with a net loss applicable to common shareholders of \$28.0 million, or a loss of \$1.94 basic and diluted income per share, in fiscal 2003. The Company reported income from continuing operations of \$2.0 million, or \$0.09 basic and \$0.07 diluted

income per share, for the year ended December 25, 2004 compared to a loss of \$21.3 million, or \$2.02 basic and diluted income per share, in 2003.

In addition to improved operating results, the increase in net income applicable to common shareholders was primarily the result of the following:

- A favorable impact of \$11.3 million due to a deferred Federal income tax provision recorded during the year ended December 27, 2003 to increase the valuation allowance and fully reserve the net deferred tax asset;
- A favorable impact of \$7.9 million on preferred stock dividends recorded in 2003 and none recorded in 2004 due to the June 2003 implementation of SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity" ("SFAS 150"). The accretion of the Series B Participating Preferred Stock ("Series B Preferred") was recorded as dividends through the June 2003 implementation of SFAS 150, and as interest expense thereafter;
- A favorable impact of \$6.6 million on net interest expense as the Series C Participating Preferred Stock ("Series C Preferred") was recorded as of its November 30, 2003 issuance date at its maximum potential cash payments in accordance with SFAS No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings;" thus, we are currently not required to record accretion of the Series C Preferred. In 2003, the Series B Preferred dividends and accretion were recorded as interest expense after the implementation of SFAS 150; and
- A favorable impact of \$3.1 million due to Compensation Continuation Agreement costs incurred during the year ended December 27, 2003. These costs included payments made to various executives and non-employee directors of the Company.

Partially offset by:

- An unfavorable impact due to the establishment of a \$0.5 million reserve for risks of litigation related to all class action lawsuits including the Company's current estimate of future legal fees to be incurred;
- An unfavorable impact of \$2.1 million due to severance, termination and facility exit costs associated with the implementation of strategies to reduce the Company's infrastructure;
- An unfavorable impact of \$1.9 million due to the recognition of the deferred gain related to the 2001 sale of our *Improvements* business during the year ended December 27, 2003;
- An unfavorable impact of \$1.6 million due to a benefit recognized during 2003 from the revision of our vacation and sick policy; and
- An unfavorable impact of \$0.2 million of special charges due to facility exit costs associated with the consolidation of the LaCrosse and Roanoke operations.

Net Revenues. Net revenues decreased by approximately \$9.6 million (2.6%) for the year ended December 25, 2004 to \$360.5 million from \$370.1 million in 2003. The decrease was primarily due to a 15.6% decline in *Domestications* revenue on a 19.2% reduction in circulation. During 2004, management purposely reduced circulation in *Domestications* during the first six months due to liquidity restraints and during the final six months due to the newly appointed President of *Domestications* assembling a team to stabilize and reposition the catalog. The impact of the decline in circulation and demand from *Domestications* was partially offset by increases in circulation for *Silhouettes* and *The Company Store* resulting in an increase in net revenues for these catalogs. Certain catalogs benefited from increased fill rates and reductions in backorders and lower order cancellations due to the additional capital secured through the Chelsey Facility and the amended Wachovia Facility. In addition, revenue relating to our membership programs increased by approximately \$1.0 million for the year ended December 25, 2004 to \$10.3 million from \$9.3 million in 2003. Internet sales revenue comprised 34.7% of combined Internet and catalog net revenues for the year ended December 25, 2004 compared with 30.3% in 2003, and have increased by approximately \$10.9 million, or 10.6%, to \$114.0 million for the year ended December 25, 2004 from \$103.1 million in 2003.

Cost of Sales and Operating Expenses. Cost of sales and operating expenses decreased by approximately \$16.7 million to \$216.9 million for the year ended December 25, 2004 as compared with \$233.6 million in 2003. Cost of sales and operating expenses decreased to 60.2% of net revenues for the year ended December 25, 2004 as

compared with 63.1% of net revenues in 2003. As a percentage of net revenues, this decrease was primarily due to a decline in merchandise costs associated with a shift from domestic to foreign-sourced goods. The balance of the decline was attributable to a combination of factors including a decline in inventory write-downs due to reduced slow moving inventory and increased sales of clearance merchandise through the Internet resulting in lower variable costs as compared with utilizing catalogs as the clearance avenue and other cost reductions.

Special Charges. In December 2000, the Company began a strategic business realignment program that resulted in the recording of special charges for severance, facility exit costs and fixed asset write-offs. The actions related to this strategic business realignment program were taken in an effort to direct our resources primarily towards a loss reduction strategy and a return to profitability. On June 30, 2004, we decided to consolidate the operations of the LaCrosse, Wisconsin fulfillment center and storage facility into the Roanoke Virginia fulfillment center by June 30, 2005. The LaCrosse fulfillment center and the LaCrosse storage facility were closed in June 2005 and August 2005 upon the expiration of their leases. This plan was prompted by excess capacity at our Roanoke facility at that time and the lack of sufficient warehouse space in the leased Wisconsin facilities to support the growth of *The Company Store* and lower shipping costs available from the Roanoke facility. Since the consolidation of our fulfillment centers, our Roanoke fulfillment center has experienced high levels of employee turnover and lower productivity that has resulted in higher costs being incurred in the fulfillment center. In addition, on November 9, 2004, we decided to relocate the *International Male* and *Undergear* catalog operations to our Corporate offices in New Jersey. The relocation was effected to consolidate operations and reduce costs while leveraging our catalog expertise in New Jersey. The relocation was completed on February 28, 2005. However, since the relocation and consolidation of the Men's apparel catalogs, the transition has negatively impacted the performance of the Men's apparel catalogs in 2005.

Total special charges increased by approximately \$1.5 million to \$1.7 million for the year ended December 25, 2004 as compared with \$0.2 million in 2003. During the year ended December 25, 2004, the Company recorded \$0.5 million and \$0.9 million in severance and related costs associated with the consolidation of the LaCrosse operations and the relocation of the *International Male* and *Undergear* catalog operations to New Jersey, respectively. In addition, we recorded an additional \$0.3 million in severance and related costs during the fourth quarter of 2004 associated with the elimination of 15 full-time company-wide positions. During the year ended December 27, 2003, we recorded \$0.2 million of employee severance costs.

Selling Expenses. Selling expenses increased by \$1.2 million to \$90.9 million for the year ended December 25, 2004 as compared with \$89.7 million in 2003. Selling expenses increased to 25.2% of net revenues for the year ended December 25, 2004 from 24.2% in 2003. As a percentage of net revenues, this change was due primarily to an increase in Internet marketing and catalog paper costs, partially offset by reduced circulation during 2004.

General and Administrative Expenses. General and administrative expenses decreased approximately \$2.3 million to \$40.4 million for the year ended December 25, 2004 from \$42.7 million in 2003. As a percentage of net revenues, general and administrative expenses decreased to 11.2% of net revenues for the year ended December 25, 2004 compared with 11.5% of net revenues in 2003. This decrease of \$2.3 million was due primarily to the net impact of certain items during 2004 and 2003, the largest of which was the higher payments for compensation continuation agreements in 2003 offset by items such as the establishment of a reserve of \$0.5 million related to class action lawsuits in 2004. See "Executive Summary."

Depreciation and Amortization. Depreciation and amortization decreased approximately \$0.8 million to \$3.3 million for the year ended December 25, 2004 from \$4.1 million in 2003. The decrease was primarily due to property and equipment that have become fully depreciated, partially offset by the depreciation of newly purchased property and equipment.

Income from Operations. The Company's income from operations increased by approximately \$7.4 million to \$7.3 million for the year ended December 25, 2004 from a loss from operations of \$0.1 million in 2003.

Gain on Sale of the Improvements Business. During the year ended December 27, 2003, the Company recognized the remaining deferred gain of \$1.9 million consistent with the terms of the March 27, 2003 amendment made to the asset purchase agreement relating to the sale of the *Improvements* business. Effective March 28, 2003,

the remaining \$2.0 million escrow balance was received by the Company, thus terminating the escrow agreement. See Note 4 of Notes to the consolidated financial statements.

Interest Expense, Net. Interest expense, net, decreased \$6.6 million to \$5.1 million for the year ended December 25, 2004 from \$11.7 million in 2003. The decrease in interest expense, net was due to the recording of \$7.6 million of Series B Preferred dividends and accretion as interest expense for the year ended December 27, 2003 based upon the treatment of the Series B Preferred as a liability as a result of the implementation of SFAS 150 and lower average cumulative borrowings relating to the Wachovia Facility. In November 2003, we exchanged the Series B Preferred for the Series C Preferred, which was accounted for in accordance with SFAS No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings." Accordingly, the Series C Preferred was recorded at its total maximum potential cash payments including dividends and other contingent amounts, and thus no dividends or interest expense on this stock has been recorded for the year ended December 25, 2004. In addition, the decrease was due to lower amortization of deferred costs as a result of the amendments to the Wachovia Facility, which have lengthened the life of the facility and therefore the amortization period. These decreases were partially offset by increases in interest expense and amortization of deferred issuance costs relating to the Chelsey Facility. See Note 7 of Notes to the consolidated financial statements.

Income Taxes. The Company's income tax provision decreased by approximately \$11.1 million to \$0.2 million for the year ended December 25, 2004 as compared with \$11.3 million in 2003. The Company had sufficient net operating loss carryovers ("NOLs") and its taxable income was below its \$382 limit to eliminate its entire 2004 regular Federal income tax. The 2004 Federal income tax provision of \$0.1 million is comprised of the Federal alternative minimum tax ("AMT"). The Company has AMT net operating loss carryovers for which utilization is limited to a maximum of 90% of AMT taxable income. See Note 12 of Notes to the consolidated financial statements for further discussion of the Company's income taxes. In addition, during the third quarter of 2003, due to a number of factors, management lowered its projections of taxable income for 2003 and 2004, which resulted in a decision to fully reserve the remaining net deferred tax asset and accordingly increased the valuation allowance by \$11.3 million.

Gain from discontinued operations of Gump's. On March 14, 2005, the Company sold all of the stock of to Gump's Holdings, LLC. The Company recognized a gain representing Gump's ongoing operations, of \$3.0 million and \$1.2 million for the years ended December 25, 2004 and December 27, 2003, respectively.

Preferred Stock Dividends. Through the end of the second quarter of 2003, the Company recorded preferred stock dividends relating to the Series B Preferred. Upon the implementation of SFAS 150 beginning in the third quarter of 2003, we were required to begin recording the preferred stock dividends as interest expense. Additionally, the Series C Preferred was recorded at the maximum amount of the liquidation preference of \$72.7 million, thus no preferred stock dividends were recorded. Therefore, during the year ended December 25, 2004, no preferred stock dividends were recorded. See Note 8 of Notes to the consolidated financial statements for an explanation regarding the Company's accounting treatment of the Series C Preferred.

Liquidity and Capital Resources

Overview

During 2005, the liquidity position of the Company strengthened as a result of improved operating results, proceeds from the sale of Gump's and as a result of securing the \$20.0 million Chelsey Facility on July 8, 2004 and concurrently amending the terms of the Wachovia Facility. The additional working capital has continued to provide us the ability to restore inventory to adequate levels in order to support higher demand. The funding has eliminated substantially all vendor restrictions involving our credit arrangements. The \$8.9 million in proceeds from the sale of Gump's enabled the Company to pay down \$8.1 million of the Wachovia revolving loan facility during the first quarter of 2005. Net cash provided by discontinued operations for December 25, 2004 and December 27, 2003 was \$1.8 million and \$2.6 million, respectively.

Net cash provided by operating activities. For the year ended December 31, 2005, net cash provided by operating activities was \$1.0 million. This was due primarily to \$16.0 million of operating cash provided by net income, when adjusted for the gain on the disposition of Gump's, depreciation, amortization and other non cash

items. These receipts of cash were largely offset by payments made by the Company to increase inventory and prepaid catalog costs and reduce accrued liabilities.

Net cash provided by investing activities. For the year ended December 31, 2005, net cash provided by investing activities was \$7.4 million. This was due primarily to \$8.9 million in proceeds received from the sale of *Gump's*, partially offset by capital expenditures, consisting primarily of purchases and upgrades to various information technology hardware and software throughout the Company and purchases of furniture and equipment for the Company's headquarters in New Jersey.

Net cash used by financing activities. For the year ended December 31, 2005, net cash used by financing activities was \$8.6 million, which was primarily due to net payments of \$8.3 million under the Wachovia Facility and payments of \$0.3 million for obligations under capital leases.

Financing Activities

Wachovia Facility. Wachovia and the Company are parties to a Loan and Security Agreement dated November 14, 1995 (as amended by the First through Thirty-Fifth Amendments, the "Wachovia Loan Agreement") pursuant to which Wachovia provided the Company with the Wachovia Facility which has included, since inception, one or more term loans and a revolving credit facility ("Revolver"). The Wachovia Facility expires on July 8, 2007.

The term loan under the Wachovia facility had a principal balance of approximately \$3.0 million as of December 31, 2005, of which approximately \$2.0 million was classified as short term and approximately \$1.0 million was classified as long term on the Consolidated Balance Sheet. The term loan bears interest at 0.5% over the Wachovia prime rate and requires monthly principal payments of approximately \$0.2 million.

The Revolver has a maximum loan limit of \$34.5 million, subject to inventory and accounts receivable sublimits that limit the credit available to the Company's subsidiaries, that are borrowers under the Revolver. The interest rate on the Revolver is currently 0.5% over the Wachovia prime rate. As of December 31, 2005, the interest rate on the Revolver was 7.5%.

The Wachovia Facility is secured by substantially all of the assets of the Company and contains certain restrictive covenants, including a restriction against the incurrence of additional indebtedness and the payment of Common Stock dividends. In addition, all of the real estate owned by the Company is subject to a mortgage in favor of Wachovia and a second mortgage in favor of Chelsey Finance. The Wachovia Loan Agreement contains affirmative and negative covenants typical for loan agreements for asset-based lending of this type including financial covenants requiring the Company to maintain specified levels of Consolidated Net Worth, Consolidated Working Capital and EBITDA, as those terms are defined in the Wachovia Loan Agreement.

2006 Amendment to Wachovia Loan Agreement - Effective March 28, 2006 the Company and Wachovia amended the Wachovia Loan Agreement ("Thirty-Fifth Amendment") which reduced the interest rate on the Revolver to the Wachovia prime rate plus 0%, eliminated the annual Revolver fee, reset certain financial covenants and consented to certain transactions between the Company's subsidiaries. There were no fees paid in connection with this amendment.

On March 28, 2006 the Company and Chelsey Finance entered into a similar amendment of the Chelsey Facility to reset certain financial covenants and consents to certain transactions.

There were \$9.2 million in letters of credit outstanding as of December 31, 2005 under the Wachovia Facility. Remaining availability under the Wachovia Facility was \$13.8 million and the interest rate was 7.5% as of December 31, 2005.

Chelsey Facility. On July 8, 2004, the Company closed on the Chelsey Facility, the \$20.0 million junior secured credit facility with Chelsey Finance that was recorded net of a debt discount at \$7.1 million at issuance. The Chelsey Facility has a three-year term, subject to earlier maturity upon the occurrence of a change in control or sale of the Company (as defined), and carries an interest rate of 5.0% above the prime rate publicly announced by Wachovia. The financial and non-financial covenants contained in the Chelsey Facility mirror those in the Wachovia Facility

except that the quantitative measures for the consolidated working capital and EBITDA covenants are 10.0% less restrictive and the consolidated net worth covenant is 5.0% less restrictive than the comparable financial covenants in the Wachovia Facility. The Chelsey Facility is secured by a second priority lien on substantially of the assets of the Company. As part of this transaction, Chelsey Finance entered into an intercreditor and subordination agreement with Wachovia. At December 31, 2005, the amount recorded as debt on the Consolidated Balance Sheet is \$11.5 million, net of the un-accreted debt discount of \$8.5 million.

In consideration for providing the Chelsey Facility to the Company, Chelsey Finance received a closing fee of \$0.2 million and a warrant (the "Common Stock Warrant") valued at \$12.9 million, exercisable immediately and for a period of ten years to purchase 30.0% of the fully diluted shares of Common Stock of the Company (equal to 10,259,366 shares of Common Stock) at an exercise price of \$0.01 per share. See Note 7 to the Company's consolidated financial statements for further information on the Chelsey Facility and the Common Stock Warrant.

Other Activities

Consolidation of New Jersey Office Facilities. The Company entered into a 10-year extension of the lease for its Weehawken, New Jersey premises and has relocated its executive offices to that facility in 2005. We consolidated all of our New Jersey operations into the Weehawken facility when the Edgewater, New Jersey facility closed upon the expiration of the lease on May 31, 2005.

Consolidation of Men's Apparel Business. On February 28, 2005 the Company completed the relocation and consolidation of all functions of *International Male* and *Undergear* from San Diego, California to Weehawken, New Jersey. We accrued \$0.9 million in severance and related costs during the fourth quarter of 2004 associated with the elimination of 32 California-based full-time equivalent positions. The payment of these costs were completed by August 2005.

The projected annual savings from the consolidation of the San Diego, California and the Edgewater, New Jersey facilities into the Weehawken, New Jersey facility is approximately \$2.1 million, however with this relocation and consolidation, the transition has negatively impacted the performance of the Men's Apparel catalogs in 2005.

Consolidation of Fulfillment Centers. On June 30, 2004 the Company announced plans to consolidate the operations of the LaCrosse, Wisconsin fulfillment center and storage facility into the Roanoke, Virginia fulfillment center by June 30, 2005. The LaCrosse fulfillment center and the LaCrosse storage facility were closed in June 2005 and August 2005 upon the expiration of their leases. This plan was prompted by excess capacity at our Roanoke facility at that time and the lack of sufficient warehouse space in the leased Wisconsin facilities to support the growth of *The Company Store* and lower shipping costs available from the Roanoke facility. We accrued \$0.5 million in severance and related costs and incurred \$0.2 million of facility exit costs during 2004 associated with the consolidation of the LaCrosse operations and the elimination of 149 full and part-time positions. The payment of these costs began in January 2005 and continued through the fourth quarter of 2005. Since the consolidation of our fulfillment centers, our Roanoke fulfillment center has experienced high levels of employee turnover and lower productivity that has resulted in higher costs being incurred in the fulfillment center. This trend of high levels of employee turnover and lower productivity continued through the end of fiscal 2005 and is expected to continue during 2006.

Pursuant to and in conjunction with the above actions to reduce overhead costs, the Company eliminated an additional 15 full-time positions Company-wide, for which we accrued \$0.3 million in severance and related costs during the fourth quarter of 2004.

Delisting of Common Stock. The Common Stock was delisted from the AMEX on February 16, 2005 ultimately because of the Restatement that prevented us from filing our Form 10-Q for the fiscal quarter ended September 25, 2004, a condition of continued AMEX listing. Trading in our Common Stock on the AMEX was halted on November 16, 2004 and formally suspended on February 2, 2005.

Current trading information about the Company's Common Stock can be obtained from the Pink Sheets (www.pinksheets.com) under the trading symbol HNVD.PK.

General. At December 31, 2005, the Company had \$0.3 million in cash and cash equivalents compared with \$0.5 million at December 25, 2004. Working capital and current ratio at December 31, 2005 were \$26.0 million and 1.42 to 1, respectively, compared with \$10.6 million and 1.13 to 1, respectively at December 25, 2004. Total recorded borrowings, net of the un-accreted debt discount of \$8.5 million and the Series C Preferred, as of December 31, 2005, aggregated \$22.6 million, \$12.5 million of which is classified as long term. Remaining availability under the Revolver as of December 31, 2005 was \$13.8 million.

At December 31, 2005, the aggregate annual principal payments required on debt instruments (including capital lease obligations) are as follows (in thousands): 2006 — \$10,105; 2007 — \$20,998.

Management believes that the Company has sufficient liquidity and availability under its credit agreements to fund its planned operations through at least the next twelve months. See “Risk Factors” in Item 1A above.

Use of Estimates and Other Critical Accounting Policies

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and revenues and expenses during the period. Significant accounting policies employed by the Company, including the use of estimates, are presented in the Notes to consolidated financial statements.

Critical accounting policies are those that are most important to the portrayal of the Company’s financial condition and results of operations, and require management’s most difficult, subjective or complex judgments, as a result of the need to make estimates about the effect of matters that are inherently uncertain. The Company’s most critical accounting policies, discussed below, pertain to revenue recognition, inventory valuation, catalog costs, reserves related to the Company’s strategic business realignment program and other accrued liabilities, reserves related to employee health, welfare and benefit plans, and the net deferred tax asset.

Revenue Recognition

Direct Commerce — The Company recognizes revenue for catalog and Internet sales at the time merchandise is received by the customer, net of estimated returns. Delivery and service charges billed to customers are also recognized as revenue at the time merchandise is received by the customer. The Company’s revenue recognition policy includes the use of estimates for the time period between shipment of merchandise by the Company and receipt of merchandise by the customer and the future amount of returns to be received on the current period’s sales. These estimates of future returns are determined using historical measures including the amount of time between the shipment of a product and its return, the overall rate of return, and the average product margin associated with the returned products. The Company’s total returns reserve at the end of 2005 and 2004 was \$2.2 million and \$2.0 million, respectively. The Company’s return rate remained constant at 10.8% at the end of 2005 and 2004.

Membership Services — Customers may purchase memberships in a number of the Company’s Buyers’ Club programs for an annual fee. For memberships purchased during the following periods, certain of the Buyers’ Club programs contained a guarantee that the customer would receive discounts or savings, at least equal to the cost of his or her membership or the Company would refund the difference with a merchandise credit at the end of the membership period: Silhouettes from July 1998 through March 2004; Domestications from April 2002 through March 2004; and Men’s Apparel from April 2003 through March 2004. For memberships purchased during the periods in which the Buyers’ Club memberships contained a guarantee, revenue net of actual cancellations was recognized on a monthly basis over the membership period subsequent to the end of the thirty-day cancellation period, with the revenue recognized equal to the lesser of the cumulative amount determined using the straight-line method or the actual benefit received by each customer as of the end of each period. For the Buyers’ Club memberships that did not contain a guarantee, revenue net of actual cancellations was recognized on a monthly basis over the membership period subsequent to the end of the thirty-day cancellation period, using the straight-line method. We receive commission revenue related to our solicitation of the Vertrue membership programs. The Company receives a monthly commission based on the number of memberships sold with additional revenue recognized if certain program performance levels are attained for each fiscal year. Through May 2003, we received commission revenue from the Magazine Direct magazine subscription program. The commission revenue we

recognized for the Magazine Direct magazine program was on a per-solicitation basis according to the number of solicitations made, with additional revenue recognized if the customer accepted the solicitation. Collectively, the amount of revenues the Company received from these sources was \$14.3 million, or 3.5% of net revenues, \$10.3 million or 2.8% of net revenues, and \$9.3 million, or 2.5% of net revenues for 2005, 2004 and 2003, respectively. In May 2003, we discontinued our solicitation of the Magazine Direct program.

Inventory Valuation — The Company's inventory valuation policy includes the use of estimates regarding the future loss on in-transit and on-hand inventory that will be sold at a price less than the cost of the inventory (inventory write-downs), plus the amount of freight-in expense associated with the inventory on-hand (capitalized freight). These amounts are included in Inventories, as recorded on the Company's Consolidated Balance Sheets. Our inventory write-downs are determined for each individual catalog using the estimated amount of overstock inventory that will need to be sold below cost and an estimate of the method of liquidating this inventory (each method generates a different level of cost recovery). Any incremental gross margin that would result in inventory being sold at a higher amount after a write-down is recorded is not realized until that inventory is ultimately sold. The estimated amount of overstock inventory is determined using current and historical sales trends for each category of inventory as well as the content of future merchandise offers that will be produced by the Company. An estimate of the percentage of freight-in expense associated with each dollar of inventory received is used in calculating the amount of freight-in expense to include in our inventory value. Different percentage estimates are developed for each catalog and for inventory purchased from foreign and domestic sources. The estimates used to determine our inventory valuation affect the balance of Inventories on the Company's Consolidated Balance Sheets and Cost of sales and operating expenses on the Company's Consolidated Statements of Income (Loss).

Prepaid Catalog Costs — Prepaid catalog costs consist of direct response advertising costs related to catalog production and mailing. In accordance with Statement of Position 93-7, "Reporting on Advertising Costs," these costs are deferred and amortized as selling expenses over the estimated period in which the sales related to such advertising are generated. An estimate of the future sales dollars to be generated from each individual catalog drop is used in the implementation of the Company's catalog cost amortization policy. The estimate of future sales is calculated for each catalog drop using historical trends for similar catalog drops mailed in prior periods as well as the overall current sales trend for the catalog. On a monthly basis, this estimate is evaluated and adjusted as necessary and then is compared with the actual sales generated to-date for the catalog drop to determine the percentage of total catalog costs to be classified as prepaid catalog costs on the Company's Consolidated Balance Sheets. The costs for each catalog drop are completely amortized, regardless of actual sales generated by the catalog drop, when the catalog has been in circulation for six months or the amount of the costs remaining to be amortized decreases below 3.0% of the catalog drop's total cost. Total selling expenses which includes both the amortization of catalog costs and other advertising expenses in the Company's Consolidated Statements of Income (Loss) was \$102.0 million, \$90.9 million and \$89.7 million for 2005, 2004 and 2003, respectively. Prepaid catalog costs at the end of 2005 and 2004 were \$17.6 million and \$15.6 million, respectively.

Reserves related to the Company's strategic business realignment program and other Accrued Liabilities — Generally, the Company records severance in accordance with the Financial Accounting Standards Board ("FASB") Statement No. 112, "Employers' Accounting for Postemployment Benefits," ("SFAS 112") and reserves for leased properties were accounted in accordance with Emerging Issues Task Force No. 94-3 ("EITF 94-3"), "Liability Recognition for Certain Employee Termination Benefits & Other Costs to Exit an Activity (Including Certain Costs Incurred in Restructuring)." The Company has not recorded any reserves under FASB Statement No. 146, "Accounting for Costs Associated with Exit or Disposal Activities". The reserves established by the Company related to its strategic business realignment program include employee severance and related costs, facility exit costs and estimates primarily associated with the potential subleasing of leased properties that have been vacated by the Company. On March 14, 2005, the *Gump's* business was sold as described in Part I of this Form 10-K. The overall reserves for leased properties that have been vacated by the Company are developed using estimates that include the potential ability to sublet leased but unoccupied properties, the length of time needed to obtain suitable tenants and the amount of rent to be received for the sublet. Real estate broker representations regarding current and future market conditions are sometimes used in estimating these items. Accrued liabilities and Other Non-current liabilities on the Company's Consolidated Balance Sheets and Special charges on the Company's Consolidated Statements of Income (Loss) are impacted by these estimates. See Note 5 and Note 6 to the Company's consolidated financial statements.

The most significant estimates involved in evaluating our accrued liabilities are used in the determination of the accrual for legal liabilities or those liabilities that will be resolved through litigation. We accrue for potential litigation losses when management determines that it is probable that an unfavorable outcome will result and the loss is reasonably estimable. Our policy is to accrue an amount equal to the estimated potential loss and associated legal fees. For the year ended December 31, 2005, the Company has \$0.1 million accrued for estimated costs associated with the Class Action Lawsuits the Company is currently litigating. See Note 15 of Notes to the consolidated financial statements for additional information pertaining to this reserve.

Reserves related to employee health, welfare and benefit plans — The Company maintains a self-insurance program related to losses and liabilities associated with employee health and welfare claims. Stop-loss coverage is held on both an aggregate and individual claim basis thereby limiting the amount of losses we will experience. Losses are accrued based upon estimates of the aggregate liability for claims incurred using our experience patterns. General and administrative expenses on the Consolidated Statement of Income (Loss) and Accrued liabilities on the Consolidated Balance Sheets are affected by these estimates. At December 31, 2005 and December 25, 2004, the Company had an accrued liability recorded in the amount of \$0.6 million.

Deferred Tax Asset - In determining the Company's net deferred tax asset (gross deferred tax asset net of a valuation allowance and the deferred tax liability), projections concerning the future utilization of the Company's net operating loss carryforwards are employed. These projections involve evaluations of our future operating plans and ability to generate taxable income, as well as future economic conditions and our future competitive environment. For the year ended December 27, 2003, the carrying value of the deferred tax asset was adjusted based on a reassessment of the Company's ability to utilize certain net operating losses prior to their expiration and our history of losses. The deferred tax asset and deferred tax liability on the Company's Consolidated Balance Sheets and the Provision for deferred income taxes on the Company's Consolidated Statements of Income (Loss) are impacted by these projections.

New Accounting Pronouncements

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs, an Amendment of ARB No. 43, Chapter 4" ("SFAS 151"), which clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs and spoilage. The Company has adopted the provisions of SFAS 151 effective January 1, 2006 and does not expect that such adoption will have a material effect on the Company's results of operations or financial position.

In December 2004, the FASB issued SFAS No. 123R, "Share Based Payment" ("SFAS 123R"). SFAS 123R requires measurement and recording of compensation expense for all employee share-based compensation awards using a fair value method. The Company currently accounts for its stock-based compensation to employees using the fair value-based methodology under SFAS 123. The Company has adopted the provisions of SFAS 123R effective January 1, 2006 and does not expect that such adoption will have a material effect on the Company's results of operations or financial position.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections" ("SFAS 154"), which changes the requirements for the accounting for and reporting of a change in accounting principle. We are required to adopt the provisions of SFAS 154 effective January 1, 2006. The Company has adopted the provisions of SFAS 154 and does not expect any current impact.

Off-Balance Sheet Arrangements and Contractual Obligations

The Company has entered into no "off-balance sheet arrangements" within the meaning of the Securities Exchange Act of 1934, as amended, and the rules thereunder other than operating leases, which are in the normal course of business and the warrants issued in conjunction with the Chelsey debt facility. These warrants are equity linked derivatives and accordingly represent off balance sheet arrangements. The warrants meet the scope exception in paragraph 11 (a) of FAS 133 and are accordingly not accounted for as derivatives for purposes of FAS 133, but instead are accounted for as equity. See Note 7 to the Company's consolidated financial statements for more information.

Provided below is a tabular disclosure of contractual obligations as of December 31, 2005, as required by Item

303(a)(5) of Regulation S-K. In addition to obligations recorded on the Company's Consolidated Balance Sheets as of December 31, 2005, the schedule includes purchase obligations, which are defined as legally binding and enforceable agreements to purchase goods or services that specify all significant terms (quantity, price, and timing of transaction).

Payment Due by Period (in thousands)

<u>Contractual Obligations</u>	<u>Total</u>	<u>Less Than 1 Year</u>	<u>1-3 Years</u>	<u>3-5 Years</u>	<u>More Than 5 Years</u>
Debt Obligations, excluding the Series C Participating Preferred Stock (a)	\$ 31,050	\$ 10,056	\$ 20,994	\$ —	\$ —
Total Minimum Lease Payments Under Capital Lease Obligations	53	49	4	—	—
Operating Lease Obligations	12,528	2,410	2,637	2,299	5,182
Operating Lease Obligations — Discontinued Operations	72	72	—	—	—
Contractual Obligations (b)	424	424	—	—	—
Purchase Obligations(c)	26,856	26,856	—	—	—
Other Long-Term Liabilities Reflected on the Registrant's Balance Sheet under GAAP (d)	<u>72,689</u>	<u>—</u>	<u>—</u>	<u>72,689</u>	<u>—</u>
Total	<u>\$143,672</u>	<u>\$ 39,867</u>	<u>\$ 23,635</u>	<u>\$ 74,988</u>	<u>\$ 5,182</u>

- (a) Represents the Company's debt obligations, including the \$20.0 million Chelsey Facility principal amount due Chelsey Finance, recorded as \$11.5 million on the Consolidated Balance Sheet. See Note 7 to the Company's consolidated financial statements for additional detail regarding the Chelsey Facility.
- (b) The Company's contractual obligations consist primarily of commitments for list processing and photography services and purchases for various packaging materials.
- (c) The Company's purchase obligations represent the estimated commitments at year-end to purchase inventory and raw materials in the normal course of business to meet operational requirements. The Company's purchase orders are not unconditional commitments, but rather represent executory contracts requiring performance by vendors/suppliers. As such the Company has an absolute and unconditional right to cancel the Purchase Order if the vendor/supplier is unable to arrange for the products listed thereon to be delivered to the destination by the date shown. The purchase obligations presented above include all such open orders and agreed upon raw material commitments that are not otherwise included in the Company's recorded liabilities.
- (d) Represents Series C Participating Preferred Stock as disclosed in Note 8 to the Company's consolidated financial statements. In March 2005 at the Company's request, Chelsey agreed to permit the Company to apply the sales proceeds from the sale of Gump's to reduce the Wachovia Facility. Chelsey retained the right to require redemption of approximately \$6.9 million (the Gump's sales proceeds available for redemption) of the Series C Preferred subject to Wachovia's approval. Since the redemption of approximately \$6.9 million is subject to Wachovia's approval the payment due period is presented as January 1, 2009.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

Interest Rates: The Company's exposure to market risk relates to interest rate fluctuations for borrowings under the Wachovia Facility, including the term loans, which bear interest at variable rates, and the Chelsey Facility, which bears interest at 5.0% above the prime rate publicly announced by Wachovia. At December 31, 2005, outstanding principal balances under the Wachovia Facility and Chelsey Facility subject to variable rates of interest were approximately \$11.1 million and \$20.0 million, respectively. If interest rates were to increase by one percent

from current levels, the resulting increase in interest expense, based upon the amount outstanding at December 31, 2005, would be approximately \$0.3 million on an annual basis.

In addition, the Company's exposure to market risk relates to customer response to the Company's merchandise offerings and circulation changes, effects of shifting patterns of e-commerce versus catalog purchases, costs associated with printing and mailing catalogs and fulfilling orders, effects of potential slowdowns or other disruptions in postal service, dependence on customers' seasonal buying patterns, fluctuations in foreign currency exchange rates, and the ability of the Company to reduce unprofitable circulation and effectively manage its customer lists.

Item 8. Financial Statements and Supplementary Data

REPORT OF THE INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors
Hanover Direct, Inc.

We have audited the accompanying consolidated balance sheets of Hanover Direct, Inc. as of December 31, 2005 and December 25, 2004, and the related consolidated statements of income (loss), cash flows and shareholders' deficiency for each of the three fiscal years in the period ended December 31, 2005. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Hanover Direct, Inc. as of December 31, 2005 and December 25, 2004 and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2005 in conformity with United States generally accepted accounting principles.

The information included on Schedule II is the responsibility of management, and although not considered necessary for a fair presentation of financial position, results of operations, and cash flows, it is presented for additional analysis and has been subjected to the auditing procedures applied in the audit of the basic consolidated financial statements. In our opinion, the information included on Schedule II relating to each of the three years in the period ended December 31, 2005 is fairly stated in all material respects, in relation to the basic consolidated financial statements taken as a whole. Also, such schedule presents fairly the information set forth therein in compliance with the applicable accounting regulations of the Securities and Exchange Commission.

/s/ GOLDSTEIN GOLUB KESSLER LLP

New York, NY
March 9, 2006

HANOVER DIRECT, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
As of December 31, 2005 and December 25, 2004

	December 31, 2005	December 25, 2004
	(In thousands of dollars, Except share amounts)	
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 275	\$ 510
Accounts receivable, net of allowance for doubtful accounts of \$916 in 2005 and \$1,367 in 2004	16,518	17,819
Inventories	51,356	53,147
Prepaid catalog costs	17,567	15,644
Other current assets	2,744	4,482
Total Current Assets	88,460	91,602
PROPERTY AND EQUIPMENT, AT COST:		
Land	4,378	4,361
Buildings and building improvements	18,194	18,221
Leasehold improvements	1,115	10,156
Furniture, fixtures and equipment	51,532	53,792
	75,219	86,530
Accumulated depreciation and amortization	(55,030)	(61,906)
Property and equipment, net	20,189	24,624
Goodwill	8,649	9,278
Deferred tax asset	2,890	2,179
Other non-current assets	1,989	2,816
Total Assets	\$ 122,177	\$ 130,499
LIABILITIES AND SHAREHOLDERS' DEFICIENCY		
CURRENT LIABILITIES:		
Short-term debt and capital lease obligations	\$ 10,105	\$ 16,690
Accounts payable	27,043	29,544
Accrued liabilities	12,341	20,535
Customer prepayments and credits	10,074	12,032
Deferred tax liability	2,890	2,179
Total Current Liabilities	62,453	80,980
NON-CURRENT LIABILITIES:		
Long-term debt (including \$11,545 and \$8,159 to a related party as of December 31, 2005 and December 25, 2004, respectively, see note 7)	12,543	11,196
Series C Participating Preferred Stock, authorized, issued and outstanding 564,819 shares at December 31, 2005 and December 25, 2004; liquidation preference was \$56,482 at December 31, 2005 and December 25, 2004	72,689	72,689
Other	40	3,286
Total Non-current Liabilities	85,272	87,171
Total Liabilities	147,725	168,151
SHAREHOLDERS' DEFICIENCY:		
Common Stock, \$0.01 par value, authorized 50,000,000 shares; 22,426,296 shares issued and outstanding at December 31, 2005 and December 25, 2004	225	225
Capital in excess of par value	460,891	460,744
Accumulated deficit	(486,664)	(498,621)
Total Shareholders' Deficiency	(25,548)	(37,652)
Total Liabilities and Shareholders' Deficiency	\$ 122,177	\$ 130,499

See notes to Consolidated Financial Statements.

HANOVER DIRECT, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME (LOSS)
For the Years Ended December 31, 2005, December 25, 2004 and December 27, 2003

	<u>2005</u>	<u>2004</u>	<u>2003</u>
	(In thousands of dollars, except per share amounts)		
NET REVENUES	\$ 407,442	\$ 360,526	\$ 370,096
OPERATING COSTS AND EXPENSES:			
Cost of sales and operating expenses	252,991	216,940	233,552
Special charges	(69)	1,684	215
Selling expenses	101,956	90,903	89,722
General and administrative expenses	32,562	40,374	42,657
Depreciation and amortization	2,866	3,312	4,093
	<u>390,306</u>	<u>353,213</u>	<u>370,239</u>
INCOME (LOSS) FROM OPERATIONS	17,136	7,313	(143)
Gain on sale of <i>Improvements</i> , net	--	--	1,911
INCOME BEFORE INTEREST AND INCOME TAXES	17,136	7,313	1,768
Interest expense, net (including interest expense to a related party; see note 7)	<u>8,146</u>	<u>5,105</u>	<u>11,715</u>
INCOME (LOSS) BEFORE INCOME TAXES	8,990	2,208	(9,947)
Provision for Federal income taxes	21	146	11,300
Provision for state income taxes	8	28	28
Provision for income taxes	<u>29</u>	<u>174</u>	<u>11,328</u>
INCOME (LOSS) FROM CONTINUING OPERATIONS	8,961	2,034	(21,275)
Gain from discontinued operations of <i>Gump's</i> , net of \$22 of income tax benefit, including a gain on disposal of \$3,576 at December 31, 2005	<u>2,996</u>	<u>2,967</u>	<u>1,215</u>
NET INCOME (LOSS) AND COMPREHENSIVE INCOME (LOSS)	11,957	5,001	(20,060)
Preferred stock dividends	--	--	7,922
Earnings Applicable to Preferred Stock	<u>294</u>	<u>124</u>	<u>--</u>
NET INCOME (LOSS) APPLICABLE TO COMMON SHAREHOLDERS	<u>\$ 11,663</u>	<u>\$ 4,877</u>	<u>\$ (27,982)</u>
NET INCOME (LOSS) PER COMMON SHARE:			
From continuing operations – basic	\$ 0.39	\$ 0.09	\$ (2.02)
From continuing operations – diluted	\$ 0.27	\$ 0.07	\$ (2.02)
From discontinued operations – basic	\$ 0.13	\$ 0.13	\$ 0.08
From discontinued operations – diluted	\$ 0.09	\$ 0.11	\$ 0.08
Net income (loss) per common share – basic	\$ 0.52	\$ 0.22	\$ (1.94)
Net income (loss) per common share - diluted	\$ 0.36	\$ 0.18	\$ (1.94)

Weighted average common shares outstanding – basic (thousands)	<u>22,426</u>	<u>22,220</u>	<u>14,439</u>
Weighted average common shares outstanding – diluted (thousands)	<u>32,588</u>	<u>27,015</u>	<u>14,439</u>

See notes to Consolidated Financial Statements.

HANOVER DIRECT, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 2005, December 25, 2004 and December 27, 2003

	2005	2004	2003
	(In thousands of dollars)		
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income (loss).....	\$ 11,957	\$ 5,001	\$ (20,060)
Adjustments to reconcile net income (loss) to net cash provided (used) by operating activities:			
Depreciation and amortization, including deferred fees	3,685	4,538	5,715
Provision for doubtful accounts	518	609	378
Special charges (income).....	(69)	1,536	1,308
Provision for deferred tax	—	—	11,300
Gain on the sale of <i>Improvements</i>	—	—	(1,911)
Gain on disposal of <i>Gump's</i>	(3,576)	—	—
Gain on the sale of property and equipment	(97)	(11)	(4)
Interest expense related to Series B Participating Preferred Stock redemption price increase	—	—	7,235
Compensation expense related to stock options	147	184	1,141
Accretion of debt discount.....	3,386	1,098	—
Changes in assets and liabilities:			
Accounts receivable.....	(1,292)	(4,093)	2,232
Inventories	(4,197)	(10,341)	11,700
Prepaid catalog costs.....	(2,806)	(3,159)	1,801
Accounts payable.....	(1)	(13,198)	(666)
Accrued liabilities	(6,832)	1,911	(11,434)
Customer prepayments and credits	(1,409)	553	1,478
Other, net	1,612	(1,893)	(2,140)
Net cash provided (used) by operating activities	<u>1,026</u>	<u>(17,265)</u>	<u>8,073</u>
CASH FLOWS FROM INVESTING ACTIVITIES:			
Acquisitions of property and equipment	(1,664)	(840)	(1,895)
Proceeds from sale of Improvements.....	—	—	2,000
Proceeds from disposal of <i>Gump's</i>	8,921	—	—
Costs related to early release of escrow funds	—	—	(89)
Proceeds from sale of property and equipment.....	106	14	78
Net cash provided (used) by investing activities	<u>7,363</u>	<u>(826)</u>	<u>94</u>
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net (payments) borrowings under Wachovia revolving loan facility	(6,342)	5,411	179
Payments under Wachovia Tranche A term loan facility	(1,991)	(1,493)	(1,991)
Payments under Wachovia Tranche B term loan facility.....	—	(6,011)	(1,800)
Borrowings under the Chelsey Facility.....	—	7,061	—
Issuance of Common Stock Warrant to related party	—	12,939	—
Payments of capital lease obligations	(291)	(690)	(466)
Payments of Series C Participating Preferred Stock financing costs	—	—	(1,334)
Payments of debt issuance costs	—	(1,045)	(910)
Payment of debt issuance costs to related party.....	—	(200)	—
Refund (payment) of estimated Richemont tax obligation on Series B Participating Preferred Stock accretion	—	347	(347)
Other, net	—	—	(1)
Net cash (used) provided by financing activities	<u>(8,624)</u>	<u>16,319</u>	<u>(6,670)</u>
Net (decrease) increase in cash and cash equivalents	(235)	(1,772)	1,497
Cash and cash equivalents at the beginning of the year.....	510	2,282	785
Cash and cash equivalents at the end of the year	<u>\$ 275</u>	<u>\$ 510</u>	<u>\$ 2,282</u>

Supplemental Disclosures of Cash Flow Information

Cash paid during the year for:

Interest	\$	4,256	\$	3,340	\$	3,325
Income taxes	\$	314	\$	9	\$	705

Non-cash investing and financing activities:

Issuance of Common Stock to related party as payment of waiver fee	\$	—	\$	563	\$	—
Series B Participating Preferred Stock redemption price increase.....	\$	—	\$	—	\$	7,575
Redemption of Series B Participating Preferred Stock	\$	—	\$	—	\$	107,536
Issuance of Series C Participating Preferred Stock.....	\$	—	\$	—	\$	72,689
Issuance of Common Stock in conjunction with Recapitalization	\$	—	\$	—	\$	19,646
Gain on issuance of Series C Participating Preferred Stock	\$	—	\$	—	\$	13,867
Tandem share expirations	\$	—	\$	350	\$	—
Retirement of Treasury Stock	\$	—	\$	3,346	\$	—
Capital lease obligations	\$	—	\$	—	\$	1,459

See notes to Consolidated Financial Statements.

HANOVER DIRECT, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' DEFICIENCY
For the Years Ended December 31, 2005, December 25, 2004 and December 27, 2003

	<u>Common Stock</u> <u>\$0.01 Par Value</u>		<u>Capital</u> <u>in Excess</u> <u>of</u> <u>Par Value</u>	<u>Accumulated</u> <u>Deficit</u>	<u>Treasury Stock</u>		<u>Notes</u> <u>Receivable</u> <u>from Sale</u> <u>of Common</u> <u>Stock</u>	<u>Total</u>
	<u>Shares</u>	<u>Amount</u>			<u>Shares</u>	<u>Amount</u>		
	(In thousands of dollars and shares)							
Balance at December 28, 2002	14,043	\$ 140	\$ 430,992	\$(490,797)	(212)	\$ (2,996)	\$ (350)	\$(63,011)
Net loss applicable to common shareholders				(27,982)				(27,982)
Series B Participating Preferred Stock liquidation preference accrual			(15,157)	15,157				—
Stock options expensed			1,141					1,141
Gain on Recapitalization, net of issuance costs of \$1,334			13,867					13,867
Issuance of Common Stock in conjunction with Recapitalization	8,186	82	19,564					19,646
Balance at December 27, 2003	22,229	\$ 222	\$ 450,407	\$(503,622)	(212)	\$ (2,996)	\$ (350)	\$(56,339)
Net income applicable to common shareholders				4,877				4,877
Earnings applicable to Series C Preferred Stock				124				124
Stock options expensed			184					184
Issuance of Common Stock for Chelsey Facility waiver fee	434	4	559					563
Issuance of Chelsey Common Stock Warrants			12,939					12,939
Tandem share expirations	(14)				(11)	(350)	350	—
Retirement of Treasury Stock	(223)	(1)	(3,345)		223	3,346		—
Balance at December 25, 2004	22,426	\$ 225	\$460,744	\$(498,621)	—	—	—	\$(37,652)
Net income applicable to common shareholders				11,663				11,663
Earnings applicable to Series C Preferred Stock				294				294
Stock options expensed			147					147
Balance at December 31, 2005	22,426	\$ 225	\$460,891	\$(486,664)	—	—	—	\$(25,548)

See notes to Consolidated Financial Statements.

HANOVER DIRECT, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2005, December 25, 2004 and December 27, 2003

1. BACKGROUND OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations — Hanover Direct, Inc., (the “Company” or we), a Delaware corporation, is a specialty direct marketer that markets a diverse portfolio of home fashions as well as men’s and women’s apparel, through mail-order catalogs and connected Internet websites directly to the consumer (“direct commerce”). The Company also manufactures super-premium down comforters, pillows and featherbeds under the *Scandia Down* brand name, which are sold through third party luxury retailers in North and South America. We provide third party, end-to-end, fulfillment, logistics, telemarketing and information technology services to businesses formerly owned by the Company and select third party companies involved in the direct marketing business.

Basis of Presentation — The consolidated financial statements include all subsidiaries of the Company, and all intercompany transactions and balances have been eliminated. The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. All references in these consolidated financial statements to the number of shares outstanding, per share amounts, stock warrants, and stock option data relating to the Company’s common stock have been restated, as appropriate, to reflect the one-for-ten reverse stock split occurring at the close of business on September 22, 2004.

On March 14, 2005, the Company sold all of the stock of Gump’s Corp. and Gump’s By Mail, Inc. (collectively, “Gump’s”) (See Note 4). The Consolidated Statements of Income reflects the Gump’s operating results and gain on sale as discontinued operations. In addition, in the Consolidated Statement of Cash Flows for the year ended December 31, 2005, the change in assets and liabilities reflects Gump’s as discontinued operations.

Fiscal Year — The Company operates on a 52 or 53-week fiscal year, ending on the last Saturday in December. The year ending December 31, 2005 was reported as a 53-week year, while the years ended December 25, 2004 and December 27, 2003 were reported as 52-week years.

Cash and Cash Equivalents — Cash includes cash equivalents consisting of highly liquid investments with an original maturity of ninety days or less.

Allowance for Doubtful Accounts — An allowance for doubtful accounts is calculated for the Company’s accounts receivable. A combination of historical and rolling bad debt rates are applied to the various receivables maintained by the Company to determine the amount of the allowance to be recorded. The Company also records additional specific allowances deemed necessary by management, based on known circumstances related to the overall receivable portfolio.

Inventories — Inventories consist principally of merchandise held for resale and are stated at the lower of cost or market. Cost, which is determined using the first-in, first-out (FIFO) method, includes the cost of the product as well as capitalized freight-in charges. Raw materials and work in process represented approximately 5% and 7% of the inventory balance as of December 31, 2005 and December 25, 2004, respectively. The Company considers slow moving inventory to be surplus and calculates a loss on the impairment as the difference between an individual item’s cost and the net proceeds anticipated to be received upon disposal. The Company utilizes various liquidation vehicles to dispose of aged inventory including special sale catalogs, sale sections within main catalogs, sale sections on the Company’s Internet websites, outlet stores and liquidations through off-price merchants. Such inventory is written down to its net realizable value if the expected proceeds of disposal are less than the cost of the merchandise.

Prepaid Catalog Costs — Prepaid catalog costs consist of direct response advertising costs related to catalog production and mailing. In accordance with Statement of Position 93-7, “Reporting on Advertising Costs,” these costs are deferred and amortized as selling expenses over the estimated period in which the sales related to such

advertising are generated. Total selling expenses which includes both the amortization of catalog costs and other advertising expenses in the Company's Consolidated Statements of Income (Loss) was \$102.0 million, \$90.9 million and \$89.7 million for 2005, 2004 and 2003, respectively. Prepaid catalog costs at the end of 2005 and 2004 were \$17.6 million and \$15.6 million, respectively.

Depreciation and Amortization — Depreciation and amortization of property and equipment is computed on the straight-line method over the following lives: buildings and building improvements, 30-40 years; furniture, fixtures and equipment, 3-10 years; and leasehold improvements, over the estimated useful lives or the terms of the related leases, whichever is shorter. Repairs and maintenance are expensed as incurred.

Assets Held under Capital Leases — Assets held under capital leases are recorded at the lower of the net present value of the minimum lease payments or the fair value of the leased asset at the inception of the lease. Amortization expense is computed using the straight-line method over the shorter of the estimated useful lives of the assets or the period of the related lease.

Goodwill — The Company accounts for goodwill in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," which requires that goodwill no longer be amortized but reviewed for impairment if impairment indicators arise and, at a minimum, annually. The Company performs its annual impairment review during its second quarter each fiscal year. The Company performs a review, at a total company-wide level since the Company is viewed as one segment, of long-lived assets using a fair-value approach utilizing appraisals to determine if impairment exists. The fair value is determined using a combination of market and discounted cash flow approaches.

Impairment of Long-lived Assets — In accordance with SFAS No.144, "Accounting for the Impairment or Disposal of Long-lived Assets" ("SFAS 144"), the Company reviews long-lived assets, other than goodwill, for impairment whenever events indicate that the carrying amount of such assets may not be fully recoverable. If impairment is determined to exist, any related impairment loss is calculated based on fair value, which is generally based on discounted future cash flows.

Reserves and accruals related to loss contingencies, litigation and legal expenses — The Company accrues for potential litigation losses when management determines that it is probable that an unfavorable outcome will result and the loss is reasonably estimable in accordance with SFAS No. 5, "Accounting for Contingencies." In addition, when a loss contingency is accrued pursuant to SFAS 5, the Company's policy is to accrue for all of the related legal fees as contemplated in EITF D-77, "Accounting for Legal Costs Expected to Be Incurred in Connection with a Loss Contingency."

Reserves related to the Company's strategic business realignment program — The reserves established by the Company related to its strategic business realignment program include employee severance and related costs, facility exit costs and estimates primarily associated with the potential subleasing of leased properties which have been vacated by the Company. The overall reserves for leased properties that have been vacated by the Company are developed using estimates that include the potential ability to sublet leased but unoccupied properties, the length of time needed to obtain suitable tenants and the amount of rent to be received for the sublet. Real estate broker representations regarding current and future market conditions are sometimes used in estimating these items. See Note 5 for additional information regarding the reserves.

Reserves related to employee health and welfare claims — The Company maintains a self-insurance program related to losses and liabilities associated with employee health and welfare claims. Stop-loss coverage is held on both an aggregate and individual claim basis; thereby, limiting the amount of losses the Company will experience. Losses are accrued based upon estimates of the aggregate liability for claims incurred using the Company's experience patterns. At December 31, 2005 and December 25, 2004, the Company had an accrued liability recorded in the amount of \$0.6 million.

Employee Benefits — Vacation and Sick Compensation — During June 2003, the Company established and issued a new Company-wide vacation and sick policy to better administer vacation and sick benefits. For purposes of the policy, employees were converted to a fiscal year for earning vacation and sick benefits. Under the new policy, vacation and sick benefits are deemed earned and thus accrued ratably throughout the fiscal year and employees must utilize all vacation and sick earned by the end of the same year. Generally, any unused vacation and

sick benefits not utilized by the end of a fiscal year will be forfeited. Before the establishment of this new policy, employees earned vacation and sick in the twelve months prior to the year that it would be utilized. The policy has been modified in certain locations to comply with state and local laws or written agreements. As a result of the transition to this new policy, the Company recognized a benefit of approximately \$1.6 million in 2003. Approximately \$0.8 million of both general and administrative expenses and operating expenses was reduced as a result of the recognition of this benefit for the year ended December 27, 2003.

Cost of Sales and operating expenses — Cost of sales and operating expenses in the Consolidated Statements of Income (Loss) include the cost of merchandise sold and merchandise delivery expenses in addition to fulfillment, telemarketing and information technology expenses. Merchandise delivery expenses consist of the cost to ship packages to the customer utilizing a variety of shipping services, as well as the cost of packaging the merchandise for shipment. Total merchandise postage expense for 2005, 2004 and 2003 was \$45.0 million, \$34.8 million and \$37.6 million, respectively. These costs are recognized upon receipt of delivery by the customer and are included in Cost of sales and operating expenses in the Company's Consolidated Statements of Income (Loss). The cost of merchandise sold and merchandise postage expense deferred for shipments in transit for 2005 and 2004 were \$1.6 million and \$1.7 million, respectively.

General and administrative expenses — General and administrative expenses in the Consolidated Statements of Income (Loss) reflect payroll and benefit expenses for the catalog and corporate management personnel, costs associated with the New Jersey facilities as well as professional fees and other corporate expenses.

Stock-Based Compensation — The Company accounts for its stock-based compensation to employees using the fair value-based methodology under SFAS No. 123, "Accounting for Stock-Based Compensation."

Income Taxes — The Company accounts for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes." SFAS No. 109 requires an asset and liability approach for financial accounting and reporting of income taxes. The provision for income taxes is based on income after adjustment for those temporary and permanent items that are not considered in the determination of taxable income. The gross deferred tax asset is the total tax benefit available from net operating loss carryovers and temporary differences. A valuation allowance is calculated, based on the Company's projections of its future taxable income, to establish the amount of deferred tax asset that the Company is expected to utilize on a "more-likely-than-not" basis. A deferred tax liability represents future taxes that may be due arising from the reversal of temporary differences. In 2003, due to a number of factors, including the annual limitation on utilization of net operating losses caused by the Chelsey Direct, LLC ("Chelsey") purchase of Richemont Finance, S.A.'s ("Richemont") stockholdings in the Company during the year (see Note 9), and lower projections of taxable income for future years, the Company made a decision to fully reserve the remaining net deferred tax asset (the gross deferred tax asset net of the then existing valuation allowance and deferred tax liability) by increasing the valuation allowance and recorded an \$11.3 million deferred income tax provision. At December 31, 2005, the Company's net deferred tax asset remains fully reserved with no additional deferred income tax provision required.

Net Income (Loss) Per Share — Net income (loss) per share is computed using the weighted average number of common shares outstanding in accordance with the provisions of SFAS No. 128, "Earnings Per Share." Basic net income (loss) per common share is calculated by dividing net income (loss) available to common shareholders, reduced for participatory interests, by the weighted average number of common shares outstanding during the period. Diluted net income (loss) per common share is calculated using the weighted average number of common shares outstanding adjusted to include the potentially dilutive effect of stock options and stock warrants. The computations of basic and diluted net income (loss) per common share are as follows (in thousands except per share amounts):

	December 31, 2005	December 25, 2004	December 27, 2003
Net income (loss)	\$ 11,957	\$ 5,001	\$ (20,060)
Less:			
Preferred stock dividends	--	--	7,922
Earnings applicable to preferred stock	294	124	--
Net income (loss) applicable to common shareholders	<u>\$ 11,663</u>	<u>\$ 4,877</u>	<u>\$ (27,982)</u>
Basic net income (loss) per common share	<u>\$ 0.52</u>	<u>\$ 0.22</u>	<u>\$ (1.94)</u>
Weighted-average common shares outstanding	<u>22,426</u>	<u>22,220</u>	<u>14,439</u>
Diluted net income (loss)	<u>\$ 11,663</u>	<u>\$ 4,877</u>	<u>\$ (27,982)</u>
Diluted net income (loss) per common share	<u>\$ 0.36</u>	<u>\$ 0.18</u>	<u>\$ (1.94)</u>
Weighted-average common shares outstanding	22,426	22,220	14,439
<i>Effect of Dilution:</i>			
Stock options	2	9	--
Stock warrants	10,160	4,786	--
Weighted-average common shares outstanding assuming dilution	<u>32,588</u>	<u>27,015</u>	<u>14,439</u>

Diluted net loss per common share excluded incremental weighted-average shares of 20,979 for the year ended December 27, 2003. These incremental weighted-average shares were related to employee stock options and were excluded due to their anti-dilutive effect. Options for which the exercise price was greater than the average market price of common shares as of the fiscal years ended 2005, 2004 and 2003 were not included in the computation of diluted earnings per share as the effect would be antidilutive. These consisted of options totaling 1,069,600 shares, 1,270,883 shares and 1,388,145 shares, respectively.

Revenue Recognition

— *Direct Commerce:* The Company recognizes revenue for catalog and Internet sales at the time merchandise is received by the customer, net of estimated returns in accordance with the provisions of Staff Accounting Bulletin (“SAB”) No. 101, “Revenue Recognition in Financial Statements,” as amended by SAB No. 104, “Revenue Recognition.” Delivery and service charges billed to customers are also recognized as revenue at the time merchandise is received by the customer. The Company’s revenue recognition policy includes the use of estimates for the time period between shipment of merchandise by the Company and receipt of merchandise by the customer and the future amount of returns to be received on the current period’s sales. The Company accrues for expected future returns that relate to sales prior to the balance sheet date utilizing a combination of historical and current trends. During October 2003, the Company modified its returns policy, which previously allowed unlimited returns, by adopting a policy that limits returns to a maximum of ninety days after the sale of the merchandise.

— *Membership Services:* Customers may purchase memberships in a number of the Company’s Buyers’ Club programs for an annual fee. For memberships purchased during the following periods, certain of the Buyers’ Club programs contained a guarantee that the customer would receive discounts or savings, at least equal to the cost of his or her membership or we would refund the difference with a merchandise credit at the end of the membership

period: Silhouettes from July 1998 through March 2004; Domestications from April 2002 through March 2004; and Men's Apparel from April 2003 through March 2004. Currently, for memberships purchased during the periods in which the Buyers' Club memberships contained a guarantee, revenue net of actual cancellations was recognized on a monthly basis over the membership period subsequent to the end of the thirty-day cancellation period, with the revenue recognized equal to the lesser of the cumulative amount determined using the straight-line method or the actual benefit received by each customer as of the end of each period. For the Buyers' Club memberships that did not contain a guarantee, revenue net of actual cancellations was recognized on a monthly basis over the membership period subsequent to the end of the thirty-day cancellation period, using the straight-line method. We also receive commission revenue related to our solicitation of the Vertrue membership programs. The Company receives a monthly commission based on the number of memberships sold with additional revenue recognized if certain program performance levels are attained for each fiscal year. The additional revenue is not recognized until the performance level is attained. Until March 21, 2006, we marketed membership programs under an agreement with MemberWorks, Incorporated (now known as "Vertrue"). After the expiration of the agreement with Vertrue, we began offering membership programs provided by Encore Marketing International ("Encore") under a two year agreement. Under our agreement with Encore, we are paid a commission for each customer who places an order for a membership program and a renewal commission for each member who is still a member at the end of the member's then current membership year. We received commission revenue from the Magazine Direct magazine subscription program through May 2003 when the program was discontinued. The commission revenue recognized by the Company for the Magazine Direct magazine program was on a per-solicitation basis according to the number of solicitations made, with additional revenue recognized if the customer accepted the solicitation. Collectively, the amount of revenues the Company received from these sources was \$14.3 million, or 3.5% of net revenues, \$10.3 million, or 2.8% of net revenues, and \$9.3 million, or 2.5% of net revenues in 2005, 2004 and 2003, respectively.

— *B-to-B Services:* Revenues from the Company's e-commerce transaction services are recognized as the related services are provided. Customers are charged on an activity unit basis, which applies a contractually specified rate according to the type of transaction service performed. Revenues recorded from the Company's B-to-B services were \$32.9 million, or 8.1% of net revenues, \$20.8 million, or 5.8% of net revenues, and \$20.0 million, or 5.4% of net revenues, for 2005, 2004 and 2003, respectively.

— *Financial Instruments:* The carrying amounts for cash and cash equivalents, accounts receivable, accounts payable, short- and long-term debt (including the Wachovia Facility and excluding the Chelsey Facility) and capital lease obligations approximate fair value due to the short maturities of these instruments. The carrying amounts for long-term debt related to the Chelsey Facility are net of the remaining un-accreted debt discount of \$8.5 million. The fair value of the long-term debt related to the Chelsey Facility is approximately equal to the gross amount outstanding under the facility of \$20.0 million since the interest rate on this loan is a floating rate of 5.0% above the prime rate publicly announced by Wachovia.

New Accounting Pronouncements

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs, an Amendment of ARB No. 43, Chapter 4" ("SFAS 151"), which clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs and spoilage. The Company has adopted the provisions of SFAS 151 effective January 1, 2006 and does not expect that such adoption will have a material effect on the Company's results of operations or financial position.

In December 2004, the FASB issued SFAS No. 123R, "Share Based Payment" ("SFAS 123R"). SFAS 123R requires measurement and recording of compensation expense for all employee share-based compensation awards using a fair value method. The Company currently accounts for its stock-based compensation to employees using the fair value-based methodology under SFAS 123. The Company has adopted the provisions of SFAS 123R effective January 1, 2006 and does not expect that such adoption will have a material effect on the Company's results of operations or financial position.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections" ("SFAS 154"), which changes the requirements for the accounting for and reporting of a change in accounting principle. We are required to adopt the provisions of SFAS 154 effective January 1, 2006. The Company has adopted the provisions of SFAS 154 and does not expect any current impact.

2. PRIOR RESTATEMENT OF FINANCIAL STATEMENTS AND OTHER RELATED MATTERS

We restated the consolidated financial statements for the fiscal years ended December 27, 2003 and December 28, 2002 which were included in the Annual Report on Form 10-K filed for the 2004 fiscal year filed on February 21, 2006. We also restated the quarterly financial information for fiscal 2003 and the first two quarters of fiscal 2004 (collectively, the “Restatement”). The Restatement corrected errors in the account treatment of (i) a guarantee related to certain of our Buyer’s Club programs, (ii) our revenue recognition policies on shipped merchandise, (iii) a reserve relating to claims for post employment benefits, (iv) customer prepayments and credits, and (v) certain other accruals. The consolidated financial statements reflect the effects of the Restatement.

As a result of the Restatement, the Audit Committee of the Board of Directors hired independent outside counsel to assist with an investigation of certain of the matters relating to the Restatement and other accounting-related matters. The Securities and Exchange Commission (“SEC”) also informed the Company that it was conducting an informal inquiry which is ongoing.

The Company’s common stock was formally suspended from trading on the American Stock Exchange (the “AMEX”) on February 2, 2005 as a result of the Company’s inability to comply with the AMEX’s continued listing standards and because the Company did not file on a timely basis its Form 10-Q for the fiscal quarter ended September 25, 2004 which in turn was attributable to the Restatement. The Common Stock was removed from listing and registration on the AMEX effective February 16, 2005. Current trading information about the Company’s common stock can be obtained from the Pink Sheets (www.pinksheets.com) under the trading symbol HNVD.PK.

3. DIVIDEND RESTRICTIONS

The Company is restricted from paying dividends on its Common Stock or from acquiring its Common Stock by covenants contained in loan agreements to which the Company is a party.

4. DIVESTITURES

Sale of Gump’s

On March 14, 2005, the Company sold all of the stock of Gump’s to Gump’s Holdings, LLC (“Purchaser”) for \$8.9 million, including a purchase price adjustment of \$0.4 million, pursuant to the terms of a February 11, 2005 Stock Purchase Agreement. The Company recognized a gain of approximately \$3.6 million in the quarter ended March 26, 2005. Chelsey Direct, LLC (“Chelsey”), as the holder of all of the Series C Participating Preferred Stock (“Series C Preferred”), consented to the application of the sales proceeds to reduce the outstanding balance of the credit facility provided by Wachovia National Bank (“Wachovia”) in lieu of the current redemption of a portion of the Series C Preferred. Chelsey expressly retained its right to require redemption of approximately \$6.9 million of the Series C Preferred subject to Wachovia’s approval.

After the sale, the Company continued as the guarantor of one of the two leases for the San Francisco building where the store is located (the Company was released from liability on the other lease). The Purchaser is required to use its commercially reasonable efforts to secure the Company’s release from the guarantee within a year of the closing. If the Purchaser cannot secure the Company’s release within a year of the closing, an affiliate of the Purchaser will either (i) transfer a percentage interest in its business so that the Company will own, indirectly, 5% interest of the Purchaser’s common stock, or (ii) provide the Company with a \$2.5 million stand-by letter of credit or other form of compensation acceptable to the Company to reimburse the Company for any liabilities the Company may incur under the guarantee until the Company is released from the guarantee or the lease is terminated. As of March 6, 2006 there are \$6.8 million (net of \$0.5 million in expected sublease income) in lease commitments for which the Company is the guarantor. Based on its evaluation, the Company has concluded it is unlikely any payments will be required under the guarantee, thus had not established a guarantee liability as of the March 14, 2005 sale date or as of December 31, 2005. To date the Purchaser has not secured the Company’s release from the guarantee and the Company has started negotiations with the Purchaser on an acceptable form of compensation.

The Company entered into a Direct Marketing Services Agreement with the Purchaser to provide telemarketing and fulfillment services for the *Gump's* catalog and direct marketing businesses for 18 months. We have the option to extend the term for an additional 18 months.

Listed below are the carrying values of the major classes of assets and liabilities of Gump's included in the Consolidated Balance Sheets:

In thousands (000's)	December 25, <u>2004</u>
Total current assets	\$ 10,842
Total non-current assets	\$ 3,221
Total assets	\$ 14,063
Total current liabilities	\$ 6,727
Total non-current liabilities	\$ 3,283
Total liabilities	\$ 10,010

Listed below are the revenues and income before income taxes included in the Consolidated Statements of Income (these results exclude certain corporate overhead charges allocated to Gump's for services provided by the Company to run the business):

In thousands (000's)	For the Year Ended December 31, <u>2005</u>	For the Year Ended December 25, <u>2004</u>	For the Year Ended December 27, <u>2003</u>
Net revenues	\$ 7,241	\$ 42,634	\$ 44,188
Income before income taxes	\$ 2,974a	\$ 2,967	\$ 1,215

a) Includes a gain on disposal of \$3,576 at December 31, 2005

Sale of Improvements Catalog

On March 27, 2003, the Company and HSN, a division of USA Networks, Inc.'s Interactive Group and purchaser of certain assets and liabilities of the Company's *Improvements* business on June 29, 2001, amended the asset purchase agreement to provide for the release of the remaining \$2.0 million balance of the escrow fund and to terminate the escrow agreement. As part of the amendment, HSN forfeited its ability to receive a reduction in the original purchase price and Keystone issued a credit to HSN for \$0.1 million. This credit was utilized by HSN during March 2003. On March 28, 2003, the remaining \$2.0 million escrow balance was received by the Company, thus terminating the escrow agreement.

During 2002, the Company recognized approximately \$0.6 million of the deferred gain consistent with the terms of the escrow agreement. Proceeds related to the deferred gain were received on July 2, 2002 and December 30, 2002 for \$0.3 million and \$0.3 million, respectively. The Company recognized the remaining net deferred gain of \$1.9 million upon the receipt of the escrow balance on March 28, 2003. This gain was reported net of the costs incurred to provide the credit to HSN of approximately \$0.1 million.

5. SPECIAL CHARGES

2004 Plan

On June 30, 2004 the Company announced its plan to consolidate the operations of the LaCrosse, Wisconsin fulfillment center and storage facility into the Roanoke, Virginia fulfillment center by June 30, 2005. The LaCrosse fulfillment center and the storage facility were closed in June 2005 and August 2005, upon the expiration of their respective leases. The Company substantially completed the consolidation into the Roanoke, Virginia fulfillment center by the end of June 2005. The Company has incurred approximately \$0.8 million in facility exit costs from the

date of the announcement through December 31, 2005. The Company accrued \$0.5 million in severance and related costs during 2004 associated with the LaCrosse operations and the elimination of 149 full and part-time positions, of which 96 employees have been or are being provided severance benefits by the Company. Since the consolidation of our fulfillment centers, our Roanoke fulfillment center has experienced high levels of employee turnover and lower productivity that has resulted in higher costs being incurred in the fulfillment center. This trend of high levels of employee turnover and lower productivity continued through the end of fiscal 2005 and is expected to continue during 2006.

On November 9, 2004, the Company decided to relocate its International Male and Undergear catalog operations to its offices in New Jersey. The Company completed the relocation on February 28, 2005. The relocation was done primarily to consolidate operations, reduce costs, and leverage its catalog expertise in New Jersey. The Company accrued \$0.9 million in severance and related costs during the fourth quarter 2004 associated with the elimination of 32 California based full-time equivalent positions. Since the relocation and consolidation of the Men's apparel catalogs, the transition has negatively impacted the performance of the Men's apparel catalogs in 2005.

During 2005, the reserve activity represents the utilization of the severance reserves established in 2004 for the LaCrosse fulfillment center and storage facility and the *International Male* and *Undergear* catalog operations as well as additional net severance reductions of less than \$0.1 million.

2000 Plan

In December 2000, the Company began a strategic business realignment program that resulted in the recording of special charges for severance, facility exit costs and fixed asset write-offs. The actions related to the strategic business realignment program were taken in an effort to direct the Company's resources primarily towards a loss reduction strategy and return to profitability.

In 2003, special charges were recorded in the amount of \$0.2 million primarily for additional severance costs associated with the Company's strategic business realignment program.

Plan Summary

At December 31, 2005, a current liability of less than \$0.1 million was included within Accrued Liabilities relating to future payments in connection with the Company's 2000 and 2004 plans. It consists of the following (in thousands):

	Severance & Personnel Costs		Real Estate Lease & Exit Costs	Information Technology Leases	Total
	<u>2004 Plan</u>	<u>2000 Plan</u>	<u>2000 Plan</u>	<u>2000 Plan</u>	
Balance at December 28, 2002	\$ --	\$ 1,452	\$ 6,417	\$ 163	\$ 8,032
2003 expenses	--	149	62	--	211
<i>Gump's</i> 2003 charges	--	142	951	--	1,093
<i>Gump's</i> Paid in 2003	--	--	(513)	--	(513)
Paid in 2003	--	(1,538)	(1,328)	(163)	(3,029)
Balance at December 27, 2003	\$ --	\$ 205	\$ 5,589	\$ --	\$ 5,794
2004 expenses (reductions)	1,664	--	20	--	1,684
<i>Gump's</i> 2004 (reductions)	--	(31)	(117)	--	(148)
<i>Gump's</i> Paid in 2004	--	--	(786)	--	(786)
Paid in 2004	(146)	(174)	(1,346)	--	(1,666)
Balance at December 25, 2004	\$ 1,518	\$ --	\$ 3,360	\$ --	\$ 4,878
2005 expenses (reductions)	(69)	--	--	--	(69)
<i>Gump's</i> Paid in 2005	--	--	(63)	--	(63)
Paid in 2005	(1,428)	--	(475)	--	(1,903)

Reductions due to sale of
Gump's
Balance at December 31, 2005

	--	--	(2,822)	--	(2,822)
	<u>\$ 21</u>	<u>\$ --</u>	<u>\$ --</u>	<u>\$ --</u>	<u>\$ 21</u>

The following is a summary of the liability related to real estate lease and exit costs, by location, as of December 25, 2004 and includes lease and exit costs related to the *Gump's* operations that were sold on March 14, 2005 (in thousands):

	December 25, 2004
<i>Gump's</i> facility, San Francisco, CA	\$ 2,885
Corporate facility, Weehawken, NJ	386
Corporate facility, Edgewater, NJ	68
Administrative and telemarketing facility, San Diego, CA	21
Total Real Estate Lease and Exit Costs	<u>\$ 3,360</u>

6. ACCRUED LIABILITIES

Accrued liabilities consist of the following (in thousands):

	December 31, 2005	December 25, 2004
Special charges	\$ 21	\$ 2,460
Reserve for future sales returns	2,240	1,985
Compensation and benefits	4,836	5,670
Income and other taxes	149	470
Litigation and other related accruals	78	5,023
Other (1)	5,017	4,927
Total	<u>\$ 12,341</u>	<u>\$ 20,535</u>

(1) Other consists of items that are individually less than 5% of current liabilities.

7. DEBT

The Company has two credit facilities: a senior secured credit facility (the "Wachovia Facility") provided by Wachovia National Bank, as successor by merger to Congress Financial Corporation ("Wachovia") and a \$20.0 million junior secured facility (the "Chelsey Facility"), provided by Chelsey Finance, LLC ("Chelsey Finance"), of which the entire \$20.0 million was borrowed by the Company. Chelsey Finance is an affiliate of Chelsey, the Company's principal shareholder.

Debt consists of the following (in thousands):

	December 31, 2005	December 25, 2004
Wachovia facility:		
Tranche A term loans – Current portion, interest rate of 7.5% in 2005 and 5.5% in 2004	\$ 1,992	\$ 1,992
Revolver, interest rate of 7.5% in 2005 and 5.5% in 2004	8,066	14,408
Capital lease obligations – Current portion	47	290
Short-term debt	<u>\$ 10,105</u>	<u>\$ 16,690</u>
Wachovia facility:		
Tranche A term loans – interest rate of 7.5% in 2005 and 5.5% in 2004	\$ 994	\$ 2,985
Chelsey facility – stated interest rate of 12.0% in 2005 and 10.0% in 2004 (5% above prime rate)	11,545	8,159
Capital lease obligations	<u>4</u>	<u>52</u>

Long-term debt	\$ 12,543	\$ 11,196
Total debt	<u>\$ 22,648</u>	<u>\$ 27,886</u>

Wachovia Facility

Wachovia and the Company are parties to a Loan and Security Agreement dated November 14, 1995 (as amended by the First through Thirty-Fifth Amendments, the “Wachovia Loan Agreement”) pursuant to which Wachovia provided the Company with the Wachovia Facility which has included, since inception, one or more term loans and a revolving credit facility (“Revolver”). The Wachovia Facility expires on July 8, 2007.

Prior to the Chelsey Facility, there were two term loans outstanding, Tranche A and Tranche B, under the Wachovia Facility. The Tranche B term loan had a principal balance of approximately \$4.9 million and bore interest at 13.0% when the Company used a portion of the proceeds of the Chelsey Facility to repay this loan on July 8, 2004. The Tranche A term loan had a principal balance of approximately \$3.0 million as of December 31, 2005, of which approximately \$2.0 million is classified as short term and approximately \$1.0 million is classified as long term on the Consolidated Balance Sheet. The Tranche A term loan bears interest at 0.5% over the Wachovia prime rate and requires monthly principal payments of approximately \$0.2 million.

The Revolver has a maximum loan limit of \$34.5 million, subject to inventory and accounts receivable sublimits that limit the credit available to the Company’s subsidiaries, which are borrowers under the Revolver. The interest rate on the Revolver is currently 0.5% over the Wachovia prime rate. As of December 31, 2005, the interest rate on the Revolver was 7.5%.

The Wachovia Facility is secured by substantially all of the assets of the Company and contains certain restrictive covenants, including a restriction against the incurrence of additional indebtedness and the payment of Common Stock dividends. In addition, all of the real estate owned by the Company is subject to a mortgage in favor of Wachovia and a second mortgage in favor of Chelsey Finance. The Wachovia Loan Agreement contains affirmative and negative covenants typical for loan agreements for asset-based lending of this type including financial covenants requiring the Company to maintain specified levels of Consolidated Net Worth, Consolidated Working Capital and EBITDA, as those terms are defined in the Wachovia Loan Agreement.

2006 Amendment to Wachovia Loan Agreement

Effective March 28, 2006 the Company and Wachovia amended the Wachovia Loan Agreement (“Thirty-Fifth Amendment”) which reduced the interest rate on the Revolver to the Wachovia prime rate plus 0%, eliminated the annual Revolver fee, reset certain financial covenants and consented to certain transactions between the Company’s subsidiaries. There were no fees paid in connection with this amendment.

On March 28, 2006 the Company and Chelsey Finance entered into a similar amendment of the Chelsey Facility to reset certain financial covenants and consents to certain transactions.

2005 Amendments to Wachovia Loan Agreement

On March 11, 2005, Wachovia consented to the sale of Gump’s and Gump’s By Mail (collectively “Gump’s”). On March 11, 2005 the Wachovia Loan Agreement was amended to temporarily increase the amount of letters of credits that the Company could issue from \$10.0 million to \$13.0 million through June 30, 2005. The Company paid Wachovia a \$25,000 fee in connection with this amendment.

On July 29, 2005 the Company and Wachovia amended the Wachovia Loan Agreement to provide the terms under which the Company could enter into the World Financial Network National Bank (“WFNNB”) Credit Card Agreement which, among other things, prohibits the use of the proceeds of the Wachovia Facility to repurchase private label and co-brand accounts created under the WFNNB Credit Card Agreement should the Company become obligated to do so, prohibits the Company from terminating the WFNNB Credit Card Agreement without Wachovia’s consent and restricts the Company from borrowing on receivables generated under the WFNNB Credit Card Agreement. The amendment also waives enumerated defaults, resets the financial covenants, reallocates the availability that was previously allocated to Gump’s among other Company subsidiaries and, retroactive to June 30, 2005, increases the amount of letter of credits that the Company can issue to \$15.0 million. The Company paid Wachovia a \$60,000 fee in connection with this amendment.

On July 29, 2005 the Company and Chelsey Finance entered into a similar amendment of the Chelsey Facility.

Based on the provisions of EITF 95-22, "Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements that Include Both a Subjective Acceleration Clause and a Lock-Box Arrangement," and certain provisions in the Wachovia Loan Agreement, the Company is required to classify the Revolver as short-term debt.

There were \$9.2 million in letters of credit outstanding as of December 31, 2005 under the Wachovia Facility. Remaining availability under the Wachovia Facility as of December 31, 2005 was \$13.8 million.

Chelsey Facility

On July 8, 2004, the Company closed on the Chelsey Facility, a \$20.0 million junior secured credit facility with Chelsey Finance that was recorded net of a debt discount, at \$7.1 million at issuance. The Chelsey Facility has a three-year term, subject to earlier maturity upon the occurrence of a change in control or sale of the Company (as defined), and carries a stated interest rate of 5.0% above the prime rate publicly announced by Wachovia. The financial and non-financial covenants contained in the Chelsey Facility mirror those in the Wachovia Facility except that the quantitative measures for the consolidated working capital and EBITDA covenants are 10.0% less restrictive and the consolidated net worth covenant is 5.0% less restrictive than the comparable financial covenants in the Wachovia Facility. The Chelsey Facility is secured by a second priority lien on substantially all of the assets of the Company. As part of this transaction, Chelsey Finance entered into an intercreditor and subordination agreement with Wachovia. At December 31, 2005, the amount recorded as debt on the Consolidated Balance Sheet is \$11.5 million, net of the un-accreted debt discount of \$8.5 million.

Under the original terms of the Chelsey Facility, the Company was obligated to make payments of principal of up to the full outstanding amount of the Chelsey Facility in each quarter, provided, among other things: (1) the aggregate amount of availability under the Wachovia Facility is at least \$7.0 million, (2) the cumulative EBITDA for the four fiscal quarters immediately preceding the quarter in which the payment is made is at least \$14.0 million, and (3) the aggregate amount of principal prepayments is no more than \$2.0 million in any quarter. Subsequent to the closing of the Chelsey Facility, the Company and Chelsey Finance amended the Chelsey Facility to provide that the Company was not obligated to make principal payments prior to the July 8, 2007, except in the event of a change in control or sale of the Company. This resulted in the recorded amount of the Chelsey Facility plus the accreted cost of the debt discount (as described below) being classified as long term on the Company's Consolidated Balance Sheets as of December 31, 2005 and December 25, 2004.

In consideration for providing the Chelsey Facility to the Company, Chelsey Finance received a closing fee of \$0.2 million and a warrant (the "Common Stock Warrant") with a fair value of \$12.9 million, exercisable immediately and for a period of ten years to purchase 30.0% of the fully diluted shares of Common Stock of the Company (equal to 10,259,366 shares of Common Stock) at an exercise price of \$0.01 per share. The closing fee of \$0.2 million was recorded as a deferred charge in other assets on the Company's Consolidated Balance Sheets and is being amortized over the three-year term of the Chelsey Facility utilizing the interest-method. Because the issuance of the Common Stock Warrant was subject to shareholder approval, the Company initially issued a warrant to Chelsey Finance to purchase newly-issued Series D Participating Preferred Stock ("Series D Preferred") that was automatically exchanged for the Common Stock Warrant on September 23, 2004 following receipt of shareholder approval.

In connection with the closing of the Chelsey Facility, Chelsey waived its blockage rights over the issuance of senior securities and received in consideration a waiver fee equal to 1.0% of the liquidation preference of the Series C Preferred, payable in 434,476 shares of Common Stock (calculated based upon the fair market value thereof two business days prior to the closing date). The \$0.6 million waiver fee was recorded as a deferred charge within other assets on the Company's Consolidated Balance Sheets and is being amortized over the remaining redemption period of the Series C Preferred utilizing the interest-method. After consideration of the waiver fee paid in Common Stock and the change in the par value of Common Stock (see note 9), the Company's Common Stock increased by less than \$0.1 million and Capital in excess of par value increased by \$0.6 million. Both the shares underlying the Common Stock Warrant and the shares issued in payment of the waiver fee are subject to an existing Registration Rights Agreement between the Company and Chelsey. The Company has assessed whether the warrants should be

classified as either a liability or equity in accordance with EITF 00-19 “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock” and concluded that since the requirements are only a “best efforts” registration requirement, the warrants should be classified as equity.

As part of the Chelsey Facility, the Company and its subsidiaries agreed to indemnify Chelsey Finance and its affiliates, which includes Chelsey, from any losses suffered arising out of the Chelsey Facility other than liabilities resulting from Chelsey Finance and its affiliates’ gross negligence or willful misconduct. The indemnification agreement is not limited as to term and does not include any limitations on maximum future payments thereunder.

The terms of the Chelsey Facility were approved by the Company’s Audit Committee, all of whose members are independent, and the Company’s Board of Directors.

On July 8, 2004, approximately \$4.9 million of the proceeds from the Chelsey Facility were used to repay the Tranche B Term Loan with the balance used to provide ongoing working capital for the Company, which has been used to reduce outstanding payables and increase inventory. The Chelsey Facility, together with the concurrent amendment of the Wachovia Facility, increased the Company’s liquidity by approximately \$25.0 million.

In accordance with Accounting Principles Board Opinion No. 14, “Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants” (“APB 14”), proceeds received from the sale of debt with detachable stock purchase warrants should be allocated to both the debt and warrants, with the portion allocable to the warrants to be accounted for as Capital in excess of par value with the remaining portion of \$7.1 million classified as debt. The fair value of the Common Stock Warrant of \$12.9 million was determined using the Black-Scholes option pricing model and is being treated as debt discount, which will be accreted as interest expense utilizing the interest method over the 36-month term of the Chelsey Facility. The assumptions used for the Black-Scholes option pricing model were as follows: risk-free interest rate of 4.5%, expected volatility of 80.59%, an expected life of ten years and no expected dividends. A summary of the debt relating to the Chelsey Facility is as follows (in thousands):

	December 31, 2005	December 25, 2004
Amount Borrowed Under the Chelsey Facility	\$ 20,000	\$ 20,000
Fair Value of Common Stock Warrant (Recorded as Capital in excess of par value)	(12,939)	(12,939)
Accretion of Debt Discount (Recorded as Interest Expense)	4,484	1,098
	<u>\$ 11,545</u>	<u>\$ 8,159</u>

For the 53- weeks ending December 31, 2005 and the 52- weeks ended December 25, 2004, the Company has incurred approximately \$5.9 million and \$2.1 million of interest expense (including the accretion of debt discount and amortization of debts costs), respectively, and has made interest payments of approximately \$2.2 million and \$0.8 million, respectively, related to the Chelsey Facility.

General

At December 31, 2005, the aggregate future annual principal payments required on debt instruments (including capital lease obligations) are as follows (in thousands): 2006 — \$10,105; 2007 — \$20,998.

8. PREFERRED STOCK

Currently, the Company has one series of preferred stock outstanding, Series C Preferred. Chelsey holds all 564,819 outstanding shares of Series C Preferred which it acquired after a series of transactions that began with its May 19, 2003 acquisition of all of the Series B Participating Preferred Stock (“Series B Preferred”) from Richemont.

Prior to Chelsey’s acquisition, Richemont held all of the 1,622,111 shares of Series B Preferred, the only preferred stock then outstanding. The Series B Preferred had a par value of \$0.01 per share and a liquidation preference initially of \$47.36 per share, increasing thereafter to a maximum of \$86.85 per share in 2005.

On May 19, 2003 Richemont sold to Chelsey all of its securities in the Company consisting of 2,944,688 shares of Common Stock and 1,622,111 shares of Series B Preferred for \$40.0 million. The Company was not a party to the transaction and did not provide Chelsey with any material non-public information nor did the Company's Board of Directors endorse the transaction. As a result of the transaction, Chelsey succeeded to Richemont's rights in the Common Stock and the Series B Preferred, including the rights of the Series B Preferred holder to a liquidation preference that was equal to approximately \$98.2 million on May 19, 2003, the date of the sale by Richemont, and that could have increased to a maximum of approximately \$146.2 million on August 23, 2005, the final Series B Preferred redemption date.

On November 30, 2003, the Company and Chelsey consummated the transactions contemplated by a Recapitalization Agreement, dated as of November 18, 2003 under which the Company recapitalized, the Company completed the reconstitution of its Board of Directors and outstanding litigation between the Company and Chelsey was settled. As part of the Recapitalization, the Company exchanged all of Chelsey's Series B Preferred for 564,819 shares of newly created \$0.01 par value Series C Preferred and 8,185,783 shares of Common Stock. The Company filed a certificate in Delaware eliminating the Series B Preferred.

Effective upon the closing of the transactions contemplated by the Recapitalization Agreement, the size of the Board of Directors was increased to nine members. For a period of two years from the closing of the Recapitalization, five of the nine directors of the Company were to be designated by Chelsey and one was to be designated by Regan Partners, L.P. Effective July 30, 2004, Basil Regan, the general partner of Regan Partners, L.P. and its designee to the Board of Directors, resigned from the Board of Directors. Regan Partners, L.P. held the right to appoint a designee to the Company's Board of Directors until the January 10, 2005 sale of Common Stock held by Regan Partners, L.P., Regan International Fund Limited and Basil Regan to Chelsey.

Because the Series B Preferred was mandatorily redeemable and thus accounted for as a liability pursuant to SFAS 150, the Company accounted for the exchange of the 1,622,111 shares of Series B Preferred for the 564,819 shares of Series C Preferred and the 8,185,783 shares of Common Stock in accordance with SFAS No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings." As such, the \$107.5 million carrying value of the Series B Preferred as of the consummation date of the exchange was compared with the fair value of the Common Stock of approximately \$19.6 million issued to Chelsey as of the consummation date and the total maximum potential cash payments of approximately \$72.7 million that could be made pursuant to the terms of the Series C Preferred. Since the carrying value, net of issuance costs of approximately \$1.3 million, exceeded these amounts by approximately \$13.9 million, pursuant to SFAS No. 15, such excess was determined to be a "gain" and the Series C Preferred was recorded at the amount of total potential cash payments (including dividends and other contingent amounts) that could be required pursuant to its terms. Because Chelsey was a significant stockholder at the time of the exchange and, as a result, a related party, the "gain" was recorded to "Capital in Excess of Par Value" within "Shareholders' Deficiency" on the accompanying Consolidated Balance Sheets.

Series C Preferred

The Series C Preferred holders are entitled to one hundred votes per share on any matter on which the Common Stock votes and are entitled to one hundred votes per share plus that number of votes equal to the dollar value of any accrued, unpaid and compounded dividends with respect to such share. The holders of the Series C Preferred are also entitled to vote as a class on any matter that would adversely affect such Series C Preferred. In addition, if the Company defaults on its obligations under the Certificate of Designations, the Recapitalization Agreement or the Wachovia Facility, then the holders of the Series C Preferred, voting as a class, shall be entitled to elect twice the number of directors as comprised the Board of Directors on the default date, and such additional directors shall be elected by the holders of record of Series C Preferred as set forth in the Certificate of Designations.

If the Company liquidates, dissolves or is wound up, the holders of the Series C Preferred are entitled to a liquidation preference of \$100 per share, or an aggregate of approximately \$56.5 million based on the shares of Series C Preferred currently owned by Chelsey, plus all accrued and unpaid dividends on the Series C Preferred. As described further below, commencing January 1, 2006, dividends are payable quarterly on the Series C Preferred at the rate of 6% per annum, but such dividends may be accrued at the Company's option. Effective October 1, 2008 and assuming the Company's election to accrue all dividends from January 1, 2006 through such date, the maximum

aggregate amount of the liquidation preference plus accrued and unpaid dividends on the Series C Preferred will be approximately \$72.7 million.

Commencing January 1, 2006, dividends are payable quarterly on the Series C Preferred at the rate of 6.0% per annum, with the preferred dividend rate increasing by 1 1/2% per annum on each anniversary of the dividend commencement date until redeemed. At the Company's option, in lieu of cash dividends, the Company may accrue dividends that will compound at a rate 1.0% higher than the applicable cash dividend rate. The Series C Preferred is entitled to participate ratably with the Common Stock on a share for share basis in any dividends or distributions on the Common Stock. The right to participate has anti-dilution protection. The Wachovia Loan Agreement currently prohibits the payment of dividends.

The Series C Preferred may be redeemed in whole and not in part, except as set forth below, at the option of the Company at any time for the liquidation preference and any accrued and unpaid dividends (the "Redemption Price"). The Series C Preferred, if not redeemed earlier, must be redeemed by the Company on January 1, 2009 (the "Mandatory Redemption Date") for the Redemption Price. If the Series C Preferred is not redeemed on or before the Mandatory Redemption Date, or if other mandatory redemptions are not made, the Series C Preferred will be entitled to elect one-half of the Company's Board of Directors. Notwithstanding the foregoing, the Company will redeem the maximum number of shares of Series C Preferred as possible with the net proceeds of certain asset and equity sales not required to be used to repay Wachovia pursuant to the terms of the Wachovia Loan Agreement, and Chelsey will be required to accept such redemptions. At the Company's request, Chelsey agreed to permit the Company to apply the sales proceeds from the sale of Gump's to reduce the Wachovia Facility. Chelsey retained the right to require redemption of approximately \$6.9 million (the Gump's sales proceeds available for redemption) of the Series C Preferred subject to Wachovia's approval.

9. CAPITAL STOCK

General — At December 31, 2005 there were 22,426,296 shares of Common Stock issued and outstanding. Additionally, an aggregate of 1,169,600 and 10,259,366 shares of Common Stock were reserved for issuance pursuant to the exercise of outstanding options and common stock warrants, respectively, at December 31, 2005. After its January 10, 2005 purchase of an aggregate of 3,799,735 shares of Common Stock formerly held by Regan Partners, L.P., Regan International Fund Limited and Basil Regan, which was reported in an SEC filing, Chelsey and related affiliates beneficially owned approximately 69% of the issued and outstanding Common Stock and approximately 76% of the Common Stock after giving effect to the exercise of all outstanding options and warrants to purchase Common Stock beneficially owned by Chelsey. In addition, Chelsey is holder of all of the Company's Series C Preferred. Including the Series C Preferred and outstanding options and warrants (after giving effect to the exercise of all outstanding options and warrants) beneficially owned by Chelsey, Chelsey maintains approximately 91% of the voting rights of the Company. Effective July 30, 2004, Basil Regan resigned from the Board of Directors and continued to hold the right to appoint a designee to the Company's Board of Directors until the January 10, 2005 sale of Common Stock held by Regan Partners, L.P., Regan International Fund Limited and Basil Regan to Chelsey.

Recapitalization — On November 30, 2003 as part of the Recapitalization, the Company issued 8,185,783 shares of Common Stock to Chelsey.

Reverse Stock Split — At the 2004 Annual Meeting of Shareholders of the Company held on August 12, 2004, the Company's shareholders approved a one-for-ten reverse stock split of the Common Stock that became effective at the close of business on September 22, 2004. The number of shares of Common Stock in these consolidated financial statements and footnotes have been adjusted to take into account the effect of the reverse stock split.

Amendment to the Company's Certificate of Incorporation — On September 22, 2004, the Company filed a Certificate of Amendment to the Company's Amended and Restated Certificate of Incorporation (1) reducing the par value of the Common Stock from \$0.66-2/3 to \$0.01 per share and reclassifying the outstanding shares of Common Stock into such lower par value shares; (2) increasing the number of authorized shares of additional Preferred Stock from 5,000,000 shares to 15,000,000 shares and making a corresponding change to the aggregate number of authorized shares of all classes of preferred stock; and (3) after giving effect to the reverse split, increasing the authorized number of shares of Common Stock from 30,000,000 shares to 50,000,000 shares and making a corresponding change to the aggregate number of authorized shares of all classes of common stock.

Retirement of Treasury Stock — The Company approved the retirement of the Company's 212,093 treasury shares on November 16, 2004. Pursuant to the Delaware General Corporation Law, such shares will assume the status of authorized and unissued shares of Common Stock of the Company.

Dividend Restrictions — The Company is restricted from paying dividends on its Common Stock or from acquiring its Common Stock under the Wachovia and Chelsey Facilities.

10. MANAGEMENT AND COMPENSATION

The Company has employment agreements with its CEO and CFO and has letter agreements with other officers. In general, the agreements have terms of up to two years and provide severance payments of up to 18 months of salary.

The Company has entered into severance and change in control agreements with various officers and other senior employees over the years. In 2005, the Company incurred an aggregate of \$0.6 million in costs for severance; in 2004 and 2003 the Company incurred an aggregate of \$2.6 million and \$2.1 million, respectively costs for severance and change in control payments.

The Company is currently involved in litigation with four former employees who were denied change in control payments.

11. EMPLOYEE BENEFIT PLANS

The Company maintains two defined contribution 401(k) plans that are available to all employees of the Company. The Company matches a percentage of employee contributions to the plans up to \$13,000. Matching contributions for both plans was \$0.4 million for fiscal year 2005 and \$0.5 million for fiscal years 2004 and 2003.

12. INCOME TAXES

On May 19, 2003 the Company had a change in control, as defined by Internal Revenue Code Section 382, which places an annual limit of \$3.0 million on the utilization of the Company's Federal income tax net operating loss ("NOL") carryovers and alternative minimum tax net operating loss ("AMT NOL") carryovers that existed prior to the change in control date. The unused portion of the \$3.0 million annual limitation for any year may be carried forward to succeeding years to increase the annual limitation for those succeeding years. In addition to the Section 382 annual limit, the utilization of AMT NOLs in any year is further limited to 90% of that year's Federal alternative minimum taxable income.

At December 31, 2005, the Company's NOLs and AMT NOLs significantly exceeded the maximum utilizable pursuant to the above limits. The Company estimates that maximum utilizable carryforwards consist of \$55.7 million of NOLs and AMT NOLs, expiring between 2019 and 2023, subject to a \$3.0 million annual limitation under Section 382 and \$1.9 million of NOLs and \$2.2 million of AMT NOLs, both expiring between 2023 and 2025, not subject to such limitation.

As a result of differences between financial and tax accounting rules, the Company recognized a long-term capital loss carryover ("LTCL") of \$27.5 million from the disposal of Gump's (see Note 4) that expires in 2010. The Company may be unable to utilize its LTCL before it expires without the sale of core assets. No such transactions are currently contemplated.

The Company has charitable contribution carryovers totaling \$0.9 million; \$0.6 million, expiring between 2006 and 2008, is subject to the same \$3.0 million annual Section 382 limit discussed above and \$0.3 million, expiring between 2008 and 2010, is not subject to such limit. The deduction for charitable contribution carryovers in any future year within the carryover period is limited, however, to the excess of 10% of taxable income, computed without the deduction for contributions, over the amount contributed in that year.

SFAS 109 requires management to assess the realizability of the Company's deferred tax assets. Realization of the future tax benefits is dependent, in part, on the Company's ability to generate taxable income within the carry forward period and the periods in which net temporary differences reverse. Future levels of operating income and taxable income are dependent upon general economic conditions, competitive pressures on sales and margins, postal and other delivery rates, and other factors beyond the Company's control. Accordingly, no assurance can be given that sufficient taxable income will be generated for utilization of the carryovers described above and reversals of temporary differences. Management believes that the \$3.6 million deferred tax asset (excluding the \$3.6 million deferred tax liability), as of December 31, 2005, represents a "more-likely-than-not" estimate of the future utilization of the above-mentioned carryovers and the reversal of temporary differences. The valuation allowance increased by \$5.7 million in 2005 and decreased by \$0.1 million in 2004. Management will continue to routinely evaluate the likelihood of future profits and the necessity of future adjustments to the valuation allowance.

The Company's Federal income tax provision consists of current income taxes of \$21,000 in 2005 and \$146,000 in 2004 and deferred income taxes of \$11.3 million in 2003. The Company's state income tax provision consists of current income taxes of \$8,000 in 2005, \$28,000 in 2004 and \$28,000 in 2003.

The components of the net deferred tax asset at December 31, 2005 and December 25, 2004 are as follows (in millions):

	<u>2005</u>			<u>2004</u>		
	<u>Current</u>	<u>Non Current</u>	<u>Total</u>	<u>Current</u>	<u>Non Current</u>	<u>Total</u>
Deferred Tax Assets						
Federal and state tax NOL, capital loss, alternative minimum tax and business tax credit carry forwards	\$ 0.9	\$ 31.6	\$ 32.5	\$ 1.4	\$ 20.1	\$ 21.5
Allowance for doubtful accounts	0.3	—	0.3	0.5	—	0.5
Property and equipment	—	2.0	2.0	—	4.0	4.0
Mailing lists and trademarks	—	0.2	0.2	—	0.3	0.3
Accrued liabilities	2.4	—	2.4	4.7	—	4.7
Customer prepayments and credits	4.3	—	4.3	4.6	—	4.6
Deferred rent credits	—	—	—	0.7	1.3	2.0
Stock option compensation	—	1.0	1.0	—	1.2	1.2
Total	<u>7.9</u>	<u>34.8</u>	<u>42.7</u>	<u>11.9</u>	<u>26.9</u>	<u>38.8</u>
Valuation allowance	<u>7.3</u>	<u>31.8</u>	<u>39.1</u>	<u>10.2</u>	<u>23.1</u>	<u>33.3</u>
Deferred tax asset, net of valuation allowance	<u>0.6</u>	<u>3.0</u>	<u>3.6</u>	<u>1.7</u>	<u>3.8</u>	<u>5.5</u>
Deferred Tax Liabilities						
Inventories	(0.2)	—	(0.2)	(0.3)	—	(0.3)
Prepaid catalog costs	(3.2)	—	(3.2)	(3.5)	—	(3.5)
Other current assets	(0.1)	—	(0.1)	(0.1)	—	(0.1)
Excess of net assets of acquired business	—	—	—	—	(1.5)	(1.5)
Other	—	(0.1)	(0.1)	—	(0.1)	(0.1)
Deferred tax liability	<u>(3.5)</u>	<u>(0.1)</u>	<u>(3.6)</u>	<u>(3.9)</u>	<u>(1.6)</u>	<u>(5.5)</u>
Net deferred tax (liability) asset	<u>\$ (2.9)</u>	<u>\$ 2.9</u>	<u>\$ 0.0</u>	<u>\$ (2.2)</u>	<u>\$ 2.2</u>	<u>\$ 0.0</u>

The Company's effective tax rate for the three fiscal years presented differs from the Federal statutory income tax rate due to the following:

	2005 Percent of Pre-tax Income	2004 Percent of Pre-tax Income	2003 Percent of Pre-tax Loss
Tax expense (benefit) at Federal statutory rate	35.0%	35.0%	(35.0)%
State and local taxes, net of Federal benefit	0.1	0.8	0.2
Permanent differences:			
\$1million salary limit and stock option compensation	—	—	9.7
Non-deductible interest expense on Series B Preferred Stock ...	—	—	25.5
Other permanent differences	(0.6)	1.7	(0.9)
Change in valuation allowance	(34.2)	(29.6)	114.4
Tax expense at effective tax rate	<u>0.3%</u>	<u>7.9%</u>	<u>113.9%</u>

13. LEASES

The Company is the lessee under certain leases that require it to pay real estate taxes and common area maintenance by the Company. Most leases are accounted for as operating leases and include various renewal options with specified minimum rentals. Rental expense for operating leases was as follows (in thousands):

	Year Ended		
	2005	2004	2003
Rent expense by lease type:			
Land and building.....	\$ 2,842	\$ 3,207	\$ 3,310
Computer equipment	142	362	1,359
Plant, office and other.....	286	327	510
Rent expense.....	<u>\$ 3,270</u>	<u>\$ 3,896</u>	<u>\$ 5,179</u>

The amounts above exclude the net minimum rentals for the *Gump's* operations of \$0.2 million, \$1.4 million and \$1.5 million for 2005, 2004 and 2003, respectively.

Future minimum lease payments as of December 31, 2005 under non-cancelable operating leases, by lease type are as follows (in thousands):

Year Ending	Land and Buildings	Computer Equipment	Plant, Office and Other	Total
2006	\$ 2,094	\$ 71	\$ 245	\$ 2,410
2007	1,157	62	146	1,365
2008	1,138	46	88	1,272
2009	1,140	—	2	1,142
2010	1,157	—	—	1,157
Thereafter (extending to 2015)	5,182	—	—	5,182
Total future minimum lease payments..	<u>\$ 11,868</u>	<u>\$ 179</u>	<u>\$ 481</u>	<u>\$ 12,528</u>

The Company leases certain machinery and equipment under agreements that are classified as capital leases. The cost of equipment under capital leases is included in the Balance Sheet in Furniture, fixtures and equipment and was \$1.5 million at both December 31, 2005 and December 25 2004. Accumulated amortization of the leased equipment at December 31, 2005 and December 25, 2004 was \$1.4 million and \$1.1 million, respectively. The future minimum lease payments as of December 31, 2005 are as follows (in thousands):

<u>Year Ending</u>	<u>Total</u>
2006	\$ 49
2007	4
Total minimum lease payments	<u>\$ 53</u>
Less:	
Amount representing interest computed at annual rates ranging from 7.5% to 8.5%	<u>(2)</u>
Present value of net minimum lease payments	51
Less:	
Current maturities of capital lease obligations.....	<u>(47)</u>
Long-term capital lease obligations	<u><u>\$ 4</u></u>

The future minimum lease payments under non-cancelable leases that remain from the Company's discontinued restaurant operations as of December 31, 2005 are as follows (in thousands):

<u>Year Ending</u>	<u>Minimum Lease Payments</u>	<u>Sublease Income</u>
2006.....	\$ 72	\$ (100)
Total minimum lease payments.....	<u>\$ 72</u>	<u>\$ (100)</u>

14. STOCK-BASED COMPENSATION PLANS

The Company has established several stock-based compensation plans for the benefit of its officers and employees. As discussed in the Summary of Significant Accounting Policies, the Company applies the fair-value-based methodology of SFAS No. 123 and, accordingly, has recorded stock compensation expense of \$0.1 million, \$0.2 million and \$1.1 million for 2005, 2004 and 2003, respectively. The information below details each of the Company's stock compensation plans, including any changes during the years presented.

1999 Stock Option Plan for Directors — In August 1999, the Board of Directors adopted the 1999 Stock Option Plan for Directors providing options to purchase shares of Common Stock to certain non-employee directors (the "Directors' Option Plan"). The Company's shareholders ratified the Directors' Option Plan at the 2000 Annual Meeting of Shareholders. Under the Directors' Option Plan, the Company may grant stock options to purchase up to 70,000 shares of Common Stock to eligible directors at an exercise price equal to the fair market value as of the grant date. An eligible director received an initial stock option grant to purchase 5,000 shares of Common Stock as of the effective date of his/her initial appointment or election to the Board of Directors. Furthermore, on each Award Date, defined as August 4, 2000 or August 3, 2001, eligible directors were granted options to purchase an additional 1,000 shares of Common Stock. Stock options granted have terms not to exceed ten years and shall be exercisable in accordance with the terms and conditions specified in each option agreement. In addition, options became exercisable over three years from the grant date. Option holders may pay for shares purchased on exercise in cash or Common Stock. As of December 31, 2005, no stock options remained outstanding or exercisable related to the 1999 Stock Option Plan for Directors.

The following table summarizes information concerning the options outstanding, granted and the weighted average exercise prices of options granted under the Directors' Option Plan:

1999 Stock Option Plan for Directors

	2005		2004		2003	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Options outstanding, beginning of period.....	7,000	\$ 18.50	42,000	\$ 16.15	42,000	\$ 16.15
Granted	—	—	—	—	—	—
Exercised.....	—	—	—	—	—	—
Forfeited.....	(7,000)	\$ 18.50	(35,000)	\$ 15.68	—	—
Options outstanding, end of period.....	—	\$ —	7,000	\$ 18.50	42,000	\$ 16.15
Options exercisable, end of period.....	—	\$ —	7,000	\$ 18.50	36,667	\$ 17.98
Weighted average fair value of options granted	\$ —		\$ —		\$ —	

2002 Stock Option Plan for Directors — In 2002, the Board of Directors adopted the 2002 Stock Option Plan for Directors providing options to purchase shares of Common Stock of the Company to certain non-employee directors (the “2002 Directors’ Option Plan”). Under the 2002 Directors’ Option Plan, the Company may issue options to eligible directors to purchase up to 90,000 shares of Common Stock at an exercise price equal to the fair market value as of the grant date. An eligible director received an initial option grant to purchase 5,000 shares of Common Stock as of the effective date of his/her initial appointment or election to the Board of Directors. On each Award Date, defined as August 2, 2002, August 1, 2003, or August 3, 2004, eligible directors were granted options to purchase additional shares of Common Stock. On August 2, 2002, each eligible director was granted options to purchase an additional 2,500 shares of Common Stock. For the August 1, 2003 and August 3, 2004 Award Dates, each eligible director was granted options to purchase an additional 3,500 shares of Common Stock. Stock options granted have terms of ten years and shall vest and become exercisable over three years from the grant date; however, due to the Recapitalization on November 30, 2003, certain options vested and became exercisable immediately. Option holders may pay for shares purchased on exercise in cash or Common Stock.

The following table summarizes information concerning the options outstanding, granted, forfeited and the weighted average exercise prices of options granted under the 2002 Directors’ Option Plan:

2002 Stock Option Plan for Directors

	2005		2004		2003	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Options outstanding, beginning of period	65,500	\$2.04	71,000	\$2.40	10,000	\$ 2.30
Granted	—	—	26,000	1.60	61,000	2.41
Exercised	—	—	—	—	—	—
Forfeited	(2,500)	2.30	(31,500)	2.49	—	—
Options outstanding, end of period	63,000	\$2.03	65,500	\$2.04	71,000	\$ 2.40
Options exercisable, end of period	44,000	\$2.20	36,167	\$2.35	47,167	\$ 2.39
Weighted average fair value of options granted	\$ —		\$ 1.11		\$ 1.83	

The fair value of each option granted is estimated on the grant date using the Black-Scholes option-pricing model. The weighted average assumptions for grants in 2004 and 2003 under the 2002 Directors’ Option Plan were

as follows: risk-free interest rate of 3.30% and 3.64%, respectively, expected volatility of 99.68% and 90.74%, respectively, expected life of four and six years, respectively, and no expected dividends.

The following table summarizes information about stock options outstanding at December 31, 2005 under the 2002 Directors' Option Plan:

2002 Stock Option Plan for Directors

<u>Exercise Price</u>	<u>Options Outstanding</u>			<u>Options Exercisable</u>	
	<u>Number Outstanding</u>	<u>Weighted Average Remaining Contractual Life</u>	<u>Weighted Average Exercise Price</u>	<u>Number Exercisable</u>	<u>Weighted Average Exercise Price</u>
\$ 1.43	21,000	8.6	\$1.43	7,000	\$1.43
\$ 1.95	5,000	7.0	\$1.95	5,000	\$1.95
\$ 2.20	15,000	7.9	\$2.20	13,333	\$2.20
\$ 2.30	5,000	8.3	\$2.30	1,667	\$2.30
\$ 2.51	7,000	7.6	\$2.51	7,000	\$2.51
\$ 2.54	5,000	7.6	\$2.54	5,000	\$2.54
\$ 2.69	5,000	7.8	\$2.69	5,000	\$2.69
	<u>63,000</u>	<u>8.0</u>	<u>\$2.03</u>	<u>44,000</u>	<u>\$2.20</u>

2004 Stock Option Plan for Directors – During 2004, the Board of Directors adopted the 2004 Stock Option Plan for Directors providing stock options to purchase shares of Common Stock of the Company to certain non-employee directors (the “2004 Directors’ Option Plan”). The Company’s shareholders ratified the 2004 Directors’ Option Plan at the 2004 Annual Meeting of Shareholders. The Company may grant options to purchase up to 100,000 shares of Common Stock to eligible directors at an exercise price equal to the fair market value as of the grant date. An eligible director will receive an initial option grant to purchase 5,000 shares of Common Stock as of the effective date of his/her appointment or election to the Board of Directors. On each Award Date, defined as August 3, 2004, August 3, 2005 and August 3, 2006, eligible directors are to be granted options to purchase additional shares of Common Stock (to the extent the 2002 Stock Option Plan for Directors did not have enough remaining shares). Stock options granted have terms of 10 years and vest over three years from the grant date; however, if there is a Change in Control (as defined in the Hanover Direct, Inc. Directors Change of Control Plan), the participant has the cumulative right to purchase up to 100% of the option shares. Option holders may pay for shares purchased on exercise in cash or Common Stock. As of December 31, 2005 no options have been granted under the 2004 Directors’ Option Plan, as the automatic grant of options on August 3, 2004 was made under the 2002 Stock Option Plan for Directors, and the non-employee directors waived their right to the automatic grant of options to be granted on August 3, 2005.

Management Stock Option Plans — The Company approved for issuance to employees 2,000,000 shares of the Company’s Common Stock pursuant to the Company’s 2000 Management Stock Option Plan and 700,000 shares of the Company’s Common Stock pursuant the Company’s 1996 Stock Option Plan. Under both plans, the option exercise price is equal to the fair market value as of the grant date. However, for stock options granted to an employee owning more than 10% of the total combined voting power of all classes of Company stock, the exercise price is equal to 110% of the fair market value of the Company’s Common Stock as of the grant date. Stock options granted to an individual employee under the 2000 Management Stock Option Plan may not exceed 100,000 shares of the Company’s Common Stock. Stock options granted to an individual employee under the 1996 Stock Option Plan may not exceed 50,000 shares of the Company’s Common Stock and may be performance-based. All options granted must be specifically identified as incentive stock options or non-qualified stock options, as defined in the Internal Revenue Code. Furthermore, the aggregate fair market value of Common Stock for which an employee is granted incentive stock options that first became exercisable during any given calendar year shall be limited to \$100,000. To the extent this limitation is exceeded, the option shall be treated as a non-qualified stock option. Stock options may be granted for terms not to exceed ten years and shall be exercisable in accordance with the terms and conditions specified in each option agreement. In the case of an employee who owns common stock possessing more than 10% of the total combined voting power of all classes of common stock, the options must become exercisable within five years. Due to the change in control that occurred on November 30, 2003, certain options became fully vested. Option holders may pay for shares purchased on exercise in cash or Common Stock.

The following table summarizes information concerning the options outstanding, granted and the weighted average exercise prices of options granted under the 1996 and 2000 Management Stock Option Plans:

1996 and 2000 Management Stock Option Plans

	2005		2004		2003	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Options outstanding, beginning of period	776,383	\$ 7.44	822,145	\$ 8.08	923,027	\$ 8.13
Granted	100,000	0.92	127,000	1.84	6,500	2.32
Exercised	—	—	—	—	—	—
Forfeited	(239,783)	7.74	(172,762)	6.39	(107,382)	8.13
Options outstanding, end of period	<u>636,600</u>	<u>\$ 6.31</u>	<u>776,383</u>	<u>\$ 7.44</u>	<u>822,145</u>	<u>\$ 8.08</u>
Options exercisable, end of period	<u>513,426</u>	<u>\$ 7.50</u>	<u>671,216</u>	<u>\$ 8.32</u>	<u>802,920</u>	<u>\$ 8.21</u>
Weighted average fair value of options granted	<u>\$ 0.51</u>		<u>\$ 1.34</u>		<u>\$ 1.62</u>	

The fair value of each option granted is estimated on the grant date using the Black-Scholes option-pricing model. The weighted average assumptions for grants in 2005, 2004 and 2003 are as follows: risk-free interest rate of 3.96%, 3.44% and 3.58%, respectively, expected volatility of 87.55%, 103.78% and 90.96%, respectively, expected lives of four, four and six years, respectively, for 2005, 2004 and 2003, and no expected dividends.

The following table summarizes information about stock options outstanding at December 31, 2005 under both the 1996 and 2000 Management Stock Option Plans:

1996 and 2000 Management Stock Option Plans

	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number exercisable	Weighted Average Exercise Price
<u>Range of Exercise Prices</u>					
\$ 0.81 to \$1.03	100,000	9.2	\$ 0.92	33,334	\$ 0.92
\$ 1.44 to \$2.10	127,000	8.4	\$ 1.84	73,417	\$ 1.90
\$ 2.40 to \$2.70	305,400	6.6	\$ 2.40	302,475	\$ 2.40
\$ 10.10 to \$14.38	10,000	0.8	\$ 14.38	10,000	\$ 14.38
\$ 17.30 to \$23.80	16,500	0.9	\$ 23.21	16,500	\$ 23.21
\$ 26.61 to \$31.88	77,700	3.3	\$ 31.26	77,700	\$ 31.26
	<u>636,600</u>	<u>6.7</u>	<u>\$ 6.31</u>	<u>513,426</u>	<u>\$ 7.50</u>

Wayne P. Garten Stock Option Agreement – During 2004, the Company granted Mr. Garten an option (the “Garten Option”) to purchase up to 100,000 shares of the Company’s Common Stock for an exercise price of \$1.95 per share. The Garten Option was not issued pursuant to any of the Company’s plans and Mr. Garten has registration rights for these options. The options vest over a two year period: one-third upon execution of the Garten Employment Agreement, one-third on May 5, 2005 and the final one-third on May 5, 2006; provided that all of the options vest and become fully exercisable upon the earliest to occur of (i) Mr. Garten’s resignation “For Good Reason” (ii) a “Change of Control” or (iii) the Company’s termination of Mr. Garten’s employment other than “For Cause” (as defined in the Garten Employment Agreement). The options expire on May 4, 2014.

The fair value of the options was estimated to be \$1.45 per share at the grant date based on the following assumptions: risk-free interest rate of 3.45%, expected life of four years, expected volatility of 103.71%, and no expected dividends. As of December 31, 2005, 66,667 options are exercisable and 100,000 shares are outstanding.

Meridian Options — In December 2000, the Company granted options (the “2000 Meridian Options”) for the purchase of an aggregate of 400,000 shares of Common Stock with an exercise price of \$2.50 per share to Meridian, an affiliate of Mr. Shull who was a former Chief Executive Officer of the Company. These options were allocated as follows: Thomas C. Shull, 270,000 shares; Paul Jen, 50,000 shares; John F. Shull, 50,000 shares; Evan M. Dudik, 20,000 shares; and Peter Schweinfurth, 10,000 shares. All of the remaining 2000 Meridian Options are vested and are due to expire on March 31, 2006.

The fair value of the 2000 Meridian Options was estimated to be \$0.70 per share at the grant date based on the following assumptions: risk-free interest rate of 6.0%, expected life of 1.5 years, expected volatility of 54.0%, and no expected dividends.

During December 2001, the Company granted to Meridian, and the Company’s Board of Directors approved, options to Meridian (the “2001 Meridian Options”) for the purchase of an additional 100,000 shares of Common Stock with an exercise price of \$3.00. These options were allocated as follows: Thomas C. Shull, 50,000 shares; Edward M. Lambert, 30,000 shares; Paul Jen, 10,000 shares; and John F. Shull, 10,000 shares. The 2001 Meridian Options vested and became exercisable on March 31, 2003, and are due to expire on March 31, 2006.

The fair value of the 2001 Meridian Options was estimated to be \$1.60 per share at the grant date based on the following assumptions: risk-free interest rate of 2.82%, expected life of 1.25 years, expected volatility of 129.73%, and no expected dividends.

The following table summarizes information concerning the options outstanding, granted and the weighted average exercise prices of options granted for the 2000 Meridian Options and the 2001 Meridian Options:

	<i>Meridian Option Plans</i>					
	2005		2004		2003	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Options outstanding, beginning of period..	370,000	\$2.64	490,000	\$2.60	490,000	\$2.60
Granted.....	—	—	—	—	—	—
Exercised.....	—	—	—	—	—	—
Forfeited.....	—	—	(120,000)	2.50	—	—
Options outstanding, end of period	<u>370,000</u>	<u>\$2.64</u>	<u>370,000</u>	<u>\$2.64</u>	<u>490,000</u>	<u>\$2.60</u>
Options exercisable, end of period.....	<u>370,000</u>	<u>\$2.64</u>	<u>370,000</u>	<u>\$2.64</u>	<u>490,000</u>	<u>\$2.60</u>

The following table summarizes information about stock options outstanding and exercisable at December 31, 2005 for the 2000 Meridian Options and the 2001 Meridian Options:

<u>Exercise Prices</u>	<i>Meridian Option Plans</i>			<i>Meridian Option Plans</i>	
	<u>Number Outstanding</u>	<u>Options Outstanding Weighted Average Remaining Contractual Life</u>	<u>Weighted Average Exercise Price</u>	<u>Options Exercisable Number Exercisable</u>	<u>Weighted Average Exercise Price</u>
\$ 2.50	270,000	0.3	\$ 2.50	270,000	\$ 2.50
\$ 3.00	100,000	0.3	\$ 3.00	100,000	\$ 3.00
	<u>370,000</u>	<u>0.3</u>	<u>\$ 2.64</u>	<u>370,000</u>	<u>\$ 2.64</u>

15. CONTINGENCIES

Rakesh K. Kaul v. Hanover Direct, Inc.. On June 28, 2001, Rakesh K. Kaul, the former President and Chief Executive Officer of the Company, filed a complaint in the Federal District Court in the Southern District of New

York seeking post employment benefits. The Company's Motion for Summary Judgment was granted in large part, dismissing most of Kaul's claims. Kaul filed an appeal and on June 28, 2005 the Second Circuit Court of Appeals denied Kaul's appeal. Kaul's right to appeal the Second Circuit's decision expired in August 2005.

Due to the expiration of Kaul's rights to pursue this claim, the Company reversed the \$4.5 million accrual related to this matter during the third fiscal quarter of 2005. This reversal reduced general and administrative expenses in the Consolidated Statements of Income (Loss) and accrued liabilities in the Consolidated Balance Sheet.

Litigation Related to Going Private Proposal:

Three substantially identical complaints have been filed against the Company, Chelsey and each of the Company's directors: the first complaint was filed in Delaware Chancery Court by Glenn Friedman and L.I.S.T., Inc. as plaintiffs on March 1, 2006; the second complaint was filed in Delaware Chancery Court by Howard Lasker as plaintiff on March 7, 2006; and the third complaint was filed in Superior Court of New Jersey Chancery Division by Feivel Gottlieb as plaintiff on March 3, 2006. In each complaint, the plaintiffs challenge Chelsey's going private proposal and allege, among other things, that the consideration to be paid in the going private proposal is unfair and grossly inadequate, that the special committee appointed by the Board of Directors of the Company cannot be expected to act independently, that Chelsey has manipulated the financial statements of the Company and its public statements in order to depress the stock price of the Company and that the proposal would freeze out the purported class members and capture the true value of the Company for Chelsey. In each complaint, plaintiffs seek class action certification, preliminary and permanent injunctive relief, rescission of the transaction if the offer is consummated and unspecified damages. The cases are in the initial pleadings phase. Based upon a preliminary analysis of the complaints, the Company believes that the complaints are without merit and intends to defend its interests vigorously.

SEC Informal Inquiry:

See Note 2 to the consolidated financial statements for a discussion of the informal inquiry being conducted by the SEC relating to the Company's financial results and financial reporting since 1998.

Class Action Lawsuits:

The Company was a party to four class action/representative lawsuits that all involved allegations that the Company's charges for insurance were invalid, unfair, deceptive and/or fraudulent. During the third quarter of 2005, the Company favorably resolved three of the cases: one was settled for an aggregate payment of \$39,500, the Company prevailed in another case which led to the plaintiff in the third case voluntarily dismissing his case. In the remaining case, Martin v. Hanover Direct, Inc., et. al., the Company prevailed in its appeal of class certification in an October 25, 2005 decision. Martin filed an Application for Rehearing and a Petition for a Writ of Certiorari in the Oklahoma Supreme Court, both of which were denied during the first quarter of 2006.

The Company established a \$0.5 million reserve during the third quarter of 2004 for the class action lawsuits described above for settlements and the Company's current estimate of future legal fees to be incurred. The balance of the reserve as of December 31, 2005 is \$0.1 million.

Claims for Post-Employment Benefits

The Company is involved in four lawsuits instituted by former employees arising from the Company's denial of change in control ("CIC") benefits under compensation continuation plans following the termination of employment.

Two of these cases arose from the circumstances surrounding the Restatement:

Charles Blue v. Hanover Direct, Inc., William Wachtel, Stuart Feldman, Wayne Garten and Robert Masson, (Supp. Ct. N.J., Law Div. Hudson Cty, Docket No.: L-5153-05) is an action instituted by the Company's former Chief Financial Officer who was terminated for cause on March 8, 2005. The complaint seeks compensatory and

punitive damages and attorney's fees and alleges retaliation, mental anguish and reputational damage, loss of earnings and employment and racial discrimination. The Company believes that Mr. Blue was properly terminated for cause and that his claims are groundless.

Frank Lengers v. Hanover Direct, Inc., Wayne Garten, William Wachtel, A. David Brown, Stuart Feldman, Paul S. Goodman, Donald Hecht and Robert Masson, (Supp. Ct. N.J., Law Div. Hudson Cty, Docket No.: L-5795-05) was brought as a result of the Company terminating the employment of its former Vice President, Treasury Operations & Risk Management, on March 8, 2005 for cause. The complaint seeks compensatory and punitive damages and attorney's fees and alleges improper denial of CIC benefits, age and disability discrimination, handicap discrimination, aiding and abetting and breach of contract. The Company believes that Mr. Lengers was properly terminated for cause and that his claims are groundless.

The Company believes that it properly denied CIC benefits with respect to each of the four former employees and that it has meritorious defenses in all of the cases and plans a vigorous defense.

In addition, the Company is involved in various routine lawsuits of a nature that is deemed customary and incidental to its businesses. In the opinion of management, the ultimate disposition of these actions will not have a material adverse effect on the Company's financial position, results of operations, or cash flows.

16. PRIVATE LABEL AND COBRAND CREDIT CARD AGREEMENT

On February 22, 2005, the Company entered into a seven year co-brand and private label credit card agreement (as amended by Amendment Number One on March 30, 2005, the "Credit Card Agreement") with World Financial Network National Bank ("WFNNB") under which WFNNB will provide private label (branded) and co-brand credit cards to the Company's customers. The Company began offering the private label credit card to its customers in April 2005. The program extends credit to our customers at no credit risk to the Company and is expected to lead to increased sales and lower expenses. WFNNB will provide a fixed dollar amount as marketing funds in the first year of which 25% of any unused amount can be utilized in the first six months of the second year and a percentage of the lesser of private label net sales or average accounts receivable balance in later years to support the Company's promotion of the program. In general, WFNNB will pay the Company proceeds from sales of Company merchandise using the cards issued under the program with no discount. In addition, WFNNB paid the Company an up-front fee when the private label plan commenced and will pay a per card fee for each card issued under the co-brand program and a percentage of the net finance charges on co-brand accounts.

If the Credit Card Agreement is terminated or expires other than as a result of a default by WFNNB, the Company will be obligated to purchase any outstanding private label accounts at their fair market value. The Company will have the option of purchasing any outstanding co-brand accounts at their fair market value when the Credit Card Agreement terminates unless the termination is attributable to the Company's default. Under the 34th Amendment to the Loan & Security Agreement executed by the Company and Wachovia on July 29, 2005, the Company is prohibited from using the Wachovia Facility to fund the purchase of the private label and co-brand accounts. As a consequence, should the Company become obligated to purchase the accounts and should it not have secured a replacement credit card program with a new credit card issuer, the Company will be forced to seek financing from a different source which financing will be subject to Wachovia's and Chelsey's approval.

17. SELECTED QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

	<u>First Quarter</u>	<u>Second Quarter</u>	<u>Third Quarter</u>	<u>Fourth Quarter</u>
	(in thousands, except per share amounts)			
2005				
Net revenues	\$ 89,682	\$ 100,231	\$ 96,839	\$ 120,690
Income before interest and income taxes	2,072	3,411	8,994	2,659
Income from continuing operations	239	1,444	6,796	482
Net income and comprehensive income	3,227	1,452	6,796	482
Net income applicable to common shareholders	\$ 3,148	\$ 1,416	\$ 6,629	\$ 470
Net Income Per Common Share:				
From continuing operations – basic	\$ 0.01	\$ 0.06	\$ 0.30	\$ 0.02
From continuing operations – diluted	\$ 0.01	\$ 0.04	\$ 0.20	\$ 0.01
From discontinued operations – basic	\$ 0.13	\$ 0.00	\$ 0.00	\$ 0.00
From discontinued operations – diluted	\$ 0.09	\$ 0.00	\$ 0.00	\$ 0.00
Net income – basic	\$ 0.14	\$ 0.06	\$ 0.30	\$ 0.02
Net income – diluted	\$ 0.10	\$ 0.04	\$ 0.20	\$ 0.01
	<u>First Quarter</u>	<u>Second Quarter</u>	<u>Third Quarter</u>	<u>Fourth Quarter</u>
	(in thousands, except per share amounts)			
2004				
Net revenues	\$ 81,281	\$ 87,744	\$ 85,443	\$ 106,058
Income before interest and income taxes	109	624	2,081	4,499
Income (loss) from continuing operations	(600)	(186)	444	2,376
Net income (loss) and comprehensive income (loss)	(796)	33	711	5,053
Net income (loss) applicable to common shareholders	\$ (796)	\$ 33	\$ 711	\$ 4,929
Net Income (Loss) Per Common Share:				
From continuing operations – basic	\$ (0.03)	\$ (0.01)	\$ 0.02	\$ 0.10
From continuing operations – diluted	\$ (0.03)	\$ (0.01)	\$ 0.01	\$ 0.07
From discontinued operations – basic	\$ (0.01)	\$ 0.01	\$ 0.01	\$ 0.12
From discontinued operations – diluted	\$ (0.01)	\$ 0.01	\$ 0.01	\$ 0.08
Net income (loss) – basic	\$ (0.04)	\$ 0.00	\$ 0.03	\$ 0.22
Net income (loss) – diluted	\$ (0.04)	\$ 0.00	\$ 0.02	\$ 0.15

SCHEDULE II

HANOVER DIRECT, INC.
VALUATION AND QUALIFYING ACCOUNTS
Years Ended December 31, 2005, December 25, 2004
and December 27, 2003
(In thousands of dollars)

<u>Column A</u>	<u>Column B</u>	<u>Column C</u>	<u>Column D</u>	<u>Column E</u>	
<u>Description</u>	<u>Restated Balance at Beginning of Period</u>	<u>Charged to Costs and Expenses</u>	<u>Charged to Other Accounts (Describe)</u>	<u>Deductions (Describe)</u>	<u>Balance at End of Period</u>
2005:					
Allowance for Doubtful Accounts Receivable	\$ 1,367	\$ 518	-	\$ 969(4)	\$ 916
Reserve for Closed Restaurant Operations	21	30	-	41(5)	10
Special Charges Reserve.....	4,878	-	-	4,857(5)	21
Reserves for Sales Returns	1,985	9,037	-	8,782(6)	2,240
Deferred Tax Asset Valuation Allowance	33,349	-	15,333(1)	9,612(7)	39,070
2004:					
Allowance for Doubtful Accounts Receivable	1,105	609	-	347(4)	1,367
Reserve for Closed Restaurant Operations	69	42	-	90(5)	21
Special Charges Reserve.....	5,794	1,536	-	2,452(5)	4,878
Reserves for Sales Returns	1,981	3,549	-	3,545(6)	1,985
Deferred Tax Asset Valuation Allowance	33,414	-	1,858(2)	1,923(8)	33,349
2003:					
Allowance for Doubtful Accounts Receivable	1,560	378	-	833(4)	1,105
Reserve for Closed Restaurant Operations	322	40	-	293(5)	69
Special Charges Reserve.....	8,032	1,304	-	3,542(6)	5,794
Reserves for Sales Returns	1,710	2,551	-	2,280(6)	1,981
Deferred Tax Asset Valuation Allowance	142,054	-	11,300(3)	119,940(9)	33,414

- (1) \$10,460 is attributable to the long-term capital loss carryover and \$4,873 is attributable to an increase in estimated utilizable NOLs.
- (2) \$1,858 represents the increase in the valuation allowance used to offset increases in temporary differences.
- (3) \$11,300 increase in the valuation allowance charged to deferred income tax provision.
- (4) Written-off.
- (5) Utilization and reversal of reserves.
- (6) Utilization of reserves.
- (7) \$5,455 represents the decrease in the allowance attributable to loss carryovers and the reversal of temporary differences caused by the sale of Gump's and \$4,157 represents the reversal of temporary differences in continuing operations.
- (8) Represents the utilization and expiration of NOLs.
- (9) \$117,671 represents the expiration of NOL and tax credit carryovers and \$2,269 is attributable to the net reversal of temporary differences.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

There were no disagreements with accountants on accounting and financial disclosure.

Item 9A. Controls and Procedures.

Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has completed an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15 under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) pursuant to Item 307 of Regulation S-K as of December 31, 2005. This evaluation has allowed management to make conclusions, as set forth below, regarding the state of the Company's disclosure controls and procedures as of December 31, 2005.

It should be noted that as a result of the Restatement of our prior period financial statements, the change in our auditors and the attendant delay in the completion of the 2004 audit and reviews of our quarterly financial statements, we were unable to file our Form 10-K for fiscal year 2004 and the Form 10-Q's for the third fiscal quarter of 2004 and the first three fiscal quarters of 2005 until February 21, 2006. During the last year and half, management has made significant improvements in our disclosure controls and procedures and has completed various action plans to remedy identified weaknesses in these controls which has enabled us to file this Annual Report on a timely basis. Subject to the foregoing, management believes that our disclosure controls are effective for purposes of Item 307 of Regulation S-K.

Changes in Internal Control Over Financial Reporting

There has been no change in internal control over financial reporting that occurred during the fourth fiscal quarter of 2005 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

Item 9B. Other Information.

None.

PART III

Item 10. Directors and Executive Officers of the Registrant

(a) Identification of Directors

The following sets forth certain information regarding the current directors of the Company as of the date hereof:

<u>Name</u>	<u>Age</u>	<u>Title and Other Information</u>	<u>Director Since</u>
Robert H. Masson	70	Mr. Masson served as Senior Vice President, Finance and Administration and Vice President and Chief Financial Officer of Parsons & Whittemore, Inc., a global pulp and paper manufacturer, from May 1990 until his retirement June 30, 2002. Prior thereto, Mr. Masson held various executive, financial and treasury roles with The Ford Motor Company, Knutson Construction Company, Ellerbe, PepsiCo, Inc. and Combustion Engineering (now part of the ABB Group). Mr. Masson currently serves as a Trustee and as the Chairman of the Finance Committee of The Naval Aviation Museum Foundation, Inc. in Pensacola, Florida. Mr. Masson was elected a director of the Company effective January 1, 2003. Mr. Masson is the Chairman of the Audit Committee and a member of the Corporate Governance and Nominating Committees.	2003
A. David Brown	63	Mr. Brown joined Linens ‘n Things, Inc., a retail chain specializing in home furnishings, as its Senior Vice President, Human Resources on March 20, 2006. Prior to joining Linens ‘n Things, Inc., Mr. Brown was the co-founder of Bridge Partners LLC, a consumer financial services and diversity headhunting firm. Prior to co-founding Bridge Partners, Mr. Brown served as a Managing Director of Whitehead Mann after having served as Vice President of the Worldwide Retail/Fashion Specialty Practice at Korn/Ferry International, an executive search and recruiting firm. Previously, Mr. Brown served for 12 years as Senior Vice President for Human Resources at R.H. Macy & Co., a nationwide chain of department stores. He was responsible for human resources and labor relations for 50,000 employees in five U.S. divisions and 17 foreign buying offices around the world. He serves on the Board of Directors of Selective Insurance Group, Inc. He is a member of the Board of Trustees of Morristown Memorial Hospital, Drew University and the Jackie Robinson Foundation. Mr. Brown was elected a director of the Company effective July 29, 2003 and is the Chairman of the Corporate Governance and Transaction Committees and a member of the Audit Committee.	2003
Wayne P. Garten	53	Mr. Garten was elected a director of the Company by Chelsey effective September 29, 2003 and appointed President and Chief Executive Officer of the Company on May 5, 2004. Mr. Garten is a member of the Executive and Nominating Committees. Prior to his appointment, Mr. Garten served as the President of Caswell-Massey Ltd., Inc., a retailer and direct marketer of fragrance and other personal care products, from January 2004. Prior thereto, Mr. Garten was a financial consultant specializing in the direct marketing industry. He was Chief Executive Officer and President of Popular Club, Inc., a direct selling, catalog marketer of apparel and general merchandise products, from 2001 to 2003. From 1997 to 2000, he was Executive Vice President and Chief Financial Officer of Micro Warehouse, Inc., an international catalog reseller of computer products. From 1983 to 1996, Mr. Garten held various financial positions at Hanover Direct and its predecessor, The Horn & Hardart Company, including Executive Vice President and Chief Financial Officer from 1989 to 1996. Mr. Garten is a Certified Public Accountant.	2003
William B. Wachtel	51	Mr. Wachtel has been a managing partner of Wachtel & Masyr, LLP, or its predecessor law firm (Gold & Wachtel, LLP), since its founding in August 1984. He is the co-founder of the Drum Major Institute, a not-for-profit organization carrying forth the legacy of Dr. Martin Luther King, Jr. Mr. Wachtel is the	2003

Manager of Chelsey. Mr. Wachtel was elected a director of the Company effective November 18, 2003, the date of the Recapitalization Agreement. Mr. Wachtel was appointed the Chairman of the Board of Directors on May 5, 2004 and is Chairman of the Nominating Committee and is a member of the Executive and Corporate Governance Committees. Mr. Wachtel is the Manager of Chelsey and Chelsey Finance and the trustee of Chelsey Capital Profit Sharing Plan which is the sole member of Chelsey and Chelsey Finance.

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|-----------------|----|---|------|
| Stuart Feldman | 46 | Mr. Feldman has been a principal of Chelsey Capital, LLC, a private hedge fund, for more than the past five years. Mr. Feldman is the principal beneficiary of Chelsey Capital Profit Sharing Plan, which is the sole member of Chelsey. Mr. Feldman was elected a director of the Company effective November 18, 2003, the date of the Recapitalization Agreement and is Chairman of the Executive Committee and a member of the Compensation Committee. Mr. Feldman is the principal beneficiary of the Chelsey Capital Profit Sharing Plan, which is the sole member of Chelsey and Chelsey Finance and the sole officer and director of DSJ International Resources Ltd., the sole sponsor of the Chelsey Capital Profit Sharing Plan. Mr. Feldman was elected a director of the Company effective November 18, 2003, the date of the Recapitalization and is Chairman of the Executive Committee and a member of the Compensation Committee. | 2003 |
| Donald Hecht | 72 | Mr. Hecht has, since 1966, together with his brother Michael Hecht, managed Hecht & Company, an accounting firm. Mr. Hecht was elected a director of the Company effective November 18, 2003, the date of the closing of the Recapitalization and is a member of the Audit and Compensation Committees. | 2003 |
| Paul S. Goodman | 51 | Mr. Goodman is the Chief Executive Officer of Billybey Ferry Company, LLC, a ferry company that provides commuter ferry service between Manhattan and New Jersey and also provides ferry cruise services. Since 2003, Mr. Goodman has been CEO of Chelsey Broadcasting Company, LLC, which owns middle market network-affiliated television stations. Until October 2002, Mr. Goodman had served as a director of Benedek Broadcasting Corporation from November 1994 and as a director of Benedek Communications Corporation from its inception. From 1983 until October 2002, Mr. Goodman was also corporate counsel to Benedek Broadcasting and Benedek Communications since its formation in 1996 until October 2002. From April 1993 to December 2002, Mr. Goodman was a member of the law firm of Shack Siegel Katz Flaherty & Goodman, P.C. From January 1990 to April 1993, Mr. Goodman was a member of the law firm of Whitman & Ransom. Mr. Goodman became a director of the Company effective April 12, 2004. Mr. Goodman is a member of the Corporate Governance Committee. | 2004 |

As provided in the Company's Certificate of Incorporation and Bylaws, Directors hold office until the next annual meeting or until their successors have been elected or until their earlier death, resignation, retirement, disqualification or removal.

(b) *Identification of Executive Officers*

Pursuant to the Company's Bylaws, the Company's officers are chosen annually by the Board of Directors and hold office until their respective successors are chosen and qualified.

Set forth below is certain information regarding the current executive officers of the Company:

<u>Name</u>	<u>Age</u>	<u>Title and Other Information</u>	<u>Office Held Since</u>
Wayne P. Garten	53	Chief Executive Officer, President and Director. Information concerning Mr. Garten appears above under Directors.	2004
Michael D. Contino	44	Executive Vice President and Chief Operating Officer since April 25, 2001. Senior Vice President and Chief Information Officer from December 1996 to April 25, 2001 and President of Keystone since November 2000. Mr. Contino joined the Company in 1995 as Director of Computer Operations and Telecommunications. Prior to 1995, Mr. Contino was the Senior Manager of IS Operations at New Hampton, Inc., a subsidiary of Spiegel, Inc., which operated several catalogs.	2001
John W. Swatek	41	Senior Vice President, Chief Financial Officer and Treasurer. Prior to joining the Company, Mr. Swatek was Vice President and Controller of Linens 'n Things, Inc., a retail chain specializing in home furnishings. Before joining Linens 'n Things, Inc. in 2001, Mr. Swatek held various positions with Micro Warehouse, Inc., an international catalog reseller of computer products, including serving as its Senior Vice President, Finance from 2000 to 2001.	2005
Daniel J. Barsky	50	Senior Vice President, General Counsel and Secretary. Prior to joining the Company, Mr. Barsky was an independent legal consultant. Mr. Barsky served as acting General Counsel to Directrix, Inc., a provider of network origination and digital video asset management and distribution services, from 2001 to 2003. From 1999 to 2001, he served as Executive Vice President, General Counsel and Secretary to American Interactive Media, Inc., which developed multi media content. From 1994 to 1999, Mr. Barsky served as Executive Vice President, General Counsel and Secretary to Spice Entertainment Companies, Inc., an operator of pay-per-view television networks.	2005
Jordan Vargas	54	Senior Vice President, Human Resources since February 2006. Prior to joining the Company, from April 1999 to February 2006, Mr. Vargas served as the Vice President Human Resources at Publisher's Clearing House, a sweepstakes and direct marketing company. Prior thereto, Mr. Vargas served as the Human Resource Business Partner for PSE&G's Fossil Generation Business unit from 1996 to 1999.	2006
Steven Lipner	57	Vice President, Taxation since October 2000. Mr. Lipner served as Director of Taxes from February 1984 to October 2000. He holds a license as a Certified Public Accountant in New York.	2000

Pursuant to the Company's Bylaws, the Company's officers are chosen annually by the Board of Directors and hold office until their respective successors are chosen and qualified.

Effective November 11, 2003 Charles E. Blue had been appointed Chief Financial Officer of the Company.

Mr. Blue's employment with the Company was terminated effective March 8, 2005 and the Company reported in a Current Report on Form 8-K that he had resigned voluntarily. The Company and Mr. Blue were unable to agree on the terms of his voluntary resignation and the Company notified Mr. Blue that his employment had been terminated for cause. John W. Swatek was appointed as Chief Financial Officer and Treasurer effective on April 4, 2005. During the interim period, Mr. Garten served as the Chief Financial Officer. Daniel J. Barsky was appointed as Senior Vice President and General Counsel on January 31, 2005 and Secretary on March 8, 2005. Jordan Vargas was appointed as Senior Vice President, Human Resources on February 7, 2006.

(c) Audit Committee Financial Expert

While the Common Stock is no longer listed on the AMEX, the Company is providing this information with regard to its compliance with the AMEX listing standards. The Company's Board of Directors has determined that the Company has at least one "audit committee financial expert" serving on the Audit Committee of the Board of Directors who is "independent" of management within the definition of such term under Rule Section 121A of the AMEX listing standards. Robert H. Masson, a member of the Board of Directors and the Chairman of its Audit Committee, is the "audit committee financial expert" serving on the Company's Audit Committee. Mr. Masson meets the AMEX requirements that at least one member of the Audit Committee be an "audit committee financial expert."

The current Audit Committee members are Messrs. Masson (Chairman), Brown and Hecht.

(d) Code of Ethics

The Company has adopted a code of ethics that applies to the Company's principal executive officer, principal financial officer and principal accounting officer and other persons performing similar functions. A copy of the code of ethics has been filed as an Exhibit to the Company's 2002 Annual Report on Form 10-K. The Company has also adopted a code of conduct that applies to the Company's directors, officers and employees. A copy of the code of conduct was filed as an Exhibit to the 2003 Annual Report on Form 10-K.

(e) Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Securities Exchange Act of 1934 requires officers, directors and beneficial owners of more than 10% of the Company's shares to file reports with the Securities and Exchange Commission and the American Stock Exchange. Based solely on a review of the reports and representations furnished to the Company during the last fiscal year by such persons, the Company believes that each of these persons is in compliance with all applicable filing requirements.

Item 11. Executive Compensation

The following table shows salaries, bonuses, and long-term compensation paid during the last three years for the Chief Executive Officer and the Company's four next most highly compensated executive officers who were serving as executive officers at the end of the Company's 2005 fiscal year.

<u>Name and Principal Position</u>	<u>Year</u>	<u>Annual Compensation Salary</u>	<u>Bonus</u>	<u>Other Annual Compensation</u>	<u>Long Term Compensation</u>	
					<u>Awards Securities Underlying Options/ SARs</u>	<u>All Other Compensation</u>
Wayne P. Garten (1) President and Chief Executive Officer	2005	\$ 600,000	\$ 250,000 (3)	—	—	\$ 11,652 (12)
	2004	\$ 380,769 (2)	\$ 300,000 (3)	\$ 14,500 (8)	200,000 (9)	\$ 4,846 (13)
	2003	—	—	\$ 101,500 (8)	5,000 (9)	—
Michael D. Contino (1) Executive Vice President & Chief Operating Officer	2005	\$ 387,000	\$ 25,000 (4)	—	—	\$ 13,630 (14)
	2004	\$ 375,837	—	—	—	\$ 13,083 (15)
	2003	\$ 393,698	\$ 263,656 (4)	—	—	\$ 151,282 (16)
John W. Swatek (1) Senior Vice President, Chief Financial Officer & Treasurer	2005	\$ 202,500	\$ 42,208 (5)	—	50,000 (10)	\$ 8,476 (17)
Daniel J. Barsky (1) Senior Vice President, General Counsel & Secretary	2005	\$ 244,615	\$ 50,000 (6)	—	50,000 (11)	\$ 1,314 (18)
Steven Lipner (1) Vice President Taxation	2005	\$ 177,520	\$ 11,000 (7)	—	—	\$ 4,014 (19)
	2004	\$ 175,520	\$ 10,000 (7)	—	—	\$ 3,927 (20)
	2003	\$ 172,924	\$ 7,768 (7)	—	—	\$ 4,220 (21)

- (1) Wayne P. Garten was appointed to the Board of Directors on September 30, 2003 and was named President and Chief Executive Officer on May 5, 2004. Mr. Contino was appointed Executive Vice President and Chief Operating Officer on April 25, 2001. John W. Swatek was appointed Senior Vice President and Chief Financial Officer on April 4, 2005. Daniel J. Barsky was appointed Senior Vice President, General Counsel and Secretary on January 31, 2005. Mr. Lipner was appointed Vice President of Taxation in 2000.
- (2) \$380,769 of salary under the May 5, 2004 Employment Agreement between Mr. Garten and the Company ("Garten Employment Agreement").
- (3) Includes the following payments for Mr. Garten: for 2005 a \$250,000 2005 performance bonus scheduled to be paid during 2006; for 2004, a \$300,000 2004 performance bonus paid during 2005.
- (4) Includes the following payments made to Mr. Contino: for 2005 a \$25,000 2005 performance bonus scheduled to be paid during 2006; for 2003 a \$193,500 transaction bonus and a \$70,156 2003 performance bonus paid in 2004.
- (5) Includes for 2005, a \$25,000 2005 performance bonus scheduled to be paid during 2006 and \$17,208 bonus per the Swatek Employment Agreement paid in 2005.
- (6) Includes for 2005, a \$50,000 2005 performance bonus scheduled to be paid during 2006.
- (7) Includes the following payments made to Mr. Lipner: for 2005, a \$11,000 2005 performance bonus scheduled to be paid during 2006; for 2004 a \$10,000 performance bonus paid during 2005; for 2003 a \$7,768 performance bonus paid in 2004.
- (8) Mr. Garten received the following payments as a member of the Board of Directors: for 2004 \$14,500 prior to his employment as President and Chief Executive Officer of the Company; for 2003 \$101,500. He was granted options to purchase 5,000 shares of Common Stock in 2003.
- (9) 200,000 options granted per the Garten Employment Agreement, half under the 2000 Management Stock Option Plan and half outside the 2000 Management Stock Option Plan. 5,000 options granted under the 2002 Stock Option Plan for directors.
- (10) 50,000 options granted per the Swatek Employment Agreement, under the 2000 Management Stock Option Plan.
- (11) 50,000 options granted per the Barsky Letter Agreement, under the 2000 Management Stock Option Plan.
- (12) Includes the following payments made by the Company on behalf of Mr. Garten in 2005: \$276 in group term life insurance premiums; \$40 in accidental death and disability insurance premiums; \$213 in core life insurance premiums; \$168 in dental insurance premiums; \$127 in long-term disability premiums; \$7,344 in health care insurance premiums and \$3,484 in matching contributions under the Company's 401(k) Savings Plan.
- (13) Includes the following payments made by the Company on behalf of Mr. Garten in 2004: \$170 in group term life insurance premiums; \$24 in accidental death and disability insurance premiums; \$119 in core life insurance premiums; \$103 in dental insurance premiums; \$85 in long-term disability premiums; \$4,345 in health care insurance premiums.
- (14) Includes payments made by the Company on behalf of Mr. Contino in 2005: \$120 in group term life insurance premiums; \$40 in accidental death and disability insurance premiums; \$213 in core life insurance premiums; \$216 in dental insurance premiums; \$127 in long-term disability premiums; \$9,414 in health care insurance premiums; and \$3,500 in matching contributions under the Company's 401(k) Savings Plan.
- (15) Includes payments made by the Company on behalf of Mr. Contino in 2004: \$120 in group term life insurance premiums; \$40 in accidental death and disability insurance premiums; \$182 in core life insurance premiums; \$219 in dental insurance premiums; \$146 in long-term disability premiums; \$8,959 in health care insurance premiums; and \$3,417 in matching contributions under the Company's 401(k) Savings Plan.
- (16) Includes payments made on behalf of Mr. Contino in 2003: \$125 in group term life insurance premiums; \$40 in accidental death and disability insurance premiums; \$162 in core life insurance premiums; \$205 in dental insurance premiums; \$159 in long-term disability premiums; \$8,195 in health care insurance

premiums; \$3,333 in matching contributions under the Company's 401 (k) Savings Plan. Also includes forgiveness of a \$75,000 non-interest-bearing loan made by the Company to Mr. Contino in January 1998. The loan was forgiven in full in accordance with its terms during January 2003. In addition to the loan forgiveness, the Company paid all applicable withholding taxes totaling \$64,063.

- (17) Includes the following payments made by the Company on behalf of Mr. Swatek in 2005: \$88 in group term life insurance premiums; \$30 in accidental death and disability insurance premiums; \$164 in core life insurance premiums; \$166 in dental insurance premiums; \$97 in long-term disability premiums; \$7,241 in health care insurance premiums; and \$690 in matching contributions under the Company's 401(k) Savings Plan.
- (18) Includes the following payments made by the Company on behalf of Mr. Barsky in 2005: \$255 in group term life insurance premiums; \$36 in accidental death and disability insurance premiums; \$197 in core life insurance premiums; \$199 in dental insurance premiums; \$117 in long-term disability premiums; and \$510 in matching contributions under the Company's 401(k) Savings Plan.
- (19) Includes the following payments made by the Company on behalf of Mr. Lipner in 2005: \$516 in group term life insurance premiums; \$40 in accidental death and disability insurance premiums; \$213 in core life insurance premiums; \$127 in long-term disability premiums; and \$3,118 in matching contributions under the Company's 401(k) Savings Plan.
- (20) Includes the following payments made by the Company on behalf of Mr. Lipner in 2004: \$516 in group term life insurance premiums; \$40 in accidental death and disability insurance premiums; \$182 in core life insurance premiums; \$146 in long-term disability premiums; and \$3,043 in matching contributions under the Company's 401(k) Savings Plan.
- (21) Includes the following payments made by the Company on behalf of Mr. Lipner in 2003: \$527 in group term life insurance premiums; \$40 in accidental death and disability insurance premiums; \$162 in core life insurance premiums; \$158 in long-term disability premiums; and \$3,333 in matching contributions under the Company's 401(k) Savings Plan.

Stock Options and Stock Appreciation Rights

The following table contains information concerning options granted to the Chief Executive Officer and the Company's four next most highly compensated executive officers who were serving as executive officers at the end of the Company's 2005 fiscal year. There were no stock appreciation rights ("SARs") granted during fiscal 2005.

Option/SAR Grants in Fiscal 2005

<u>Name</u>	<u>Individual Grants</u>					
	<u>Number of Securities Underlying Options/SARs Granted</u>	<u>Percentage of Total Options/SARs Granted to Employees in Fiscal Year 2005</u>	<u>Exercise or Base Price</u>	<u>Market Price on Date of Grant</u>	<u>Expiration Date</u>	<u>Grant Date Value(\$)</u>
Daniel J. Barsky.....	50,000	50.0%	\$1.03	\$0.80	2/17/2015	24,195
John W. Swatek.....	50,000	50.0%	\$0.81	\$0.83	4/4/2015	26,915

The following table contains information concerning the fiscal 2005 year-end values of all options and SARs granted to the Chief Executive Officer and the Company's four (4) next most highly compensated executive officers who were serving as executive officers at the end of the Company's 2005 fiscal year.

Aggregated Option/SAR Exercises in 2005 Fiscal Year and December 31, 2005 Option/SAR Values

<u>Name</u>	<u>Shares Acquired on Exercise(#)</u>	<u>Value Realized(\$)</u>	<u>Number of Securities Underlying Unexercised Options/SARs at December 31, 2005</u> <u>Exercisable/Unexercisable</u>	<u>Value of Unexercised In-the-Money Options/SARs at December 31, 2005</u> <u>Exercisable/Unexercisable</u>
Wayne P. Garten.....	--	--	138,334 exercisable 66,666 unexercisable	\$0/\$0
Michael D. Contino	--	--	125,000 exercisable 0 unexercisable	\$0/\$0
Daniel J. Barsky.....	--	--	16,667 exercisable 33,333 unexercisable	\$7,834/\$15,667
John W. Swatek.....	--	--	16,667 exercisable 33,333 unexercisable	\$11,500/\$23,000
Steven Lipner.....	--	--	7,000 exercisable 0 unexercisable	\$0/\$0

Director Compensation

Standard Arrangements. The Company pays its non-employee directors a \$58,000 annual fee; no supplemental fees are paid for serving as Chairman of a Board committee or for attending Board meetings. Non-employee directors also participated in the 1999 Stock Option Plan for Directors ("1999 Directors' Plan") and the 2002 Stock Option Plan for Directors ("2002 Directors' Plan") and may in the future participate in the 2004 Stock Option Plan for Directors (the "2004 Directors' Option Plan"). See "Employment Contracts, Termination of Employment and Change-in-Control Arrangements." The Company does not compensate its employees, or employees of its subsidiaries, who serve as directors. During fiscal 2005, the Company also provided \$50,000 of term life insurance for each director.

Effective January 1, 2003, the 2002 Directors' Plan was amended to increase the annual award for non-employee directors from options to purchase 2,500 shares to 3,500 shares of Common Stock. In November 2003, the 2002 Directors' Plan was amended to increase the pool of options to purchase shares of Common Stock from 50,000 to

90,000 shares of Common Stock. No options were granted or exercised by Directors during 2005. As of December 31, 2005, 63,000 options to purchase Common Stock under the 2002 Stock Option Plan for Directors were outstanding, 44,000 of which were exercisable.

2004 Stock Option Plan for Directors – During 2004, the Board of Directors adopted the 2004 Directors’ Option Plan, pursuant to which stock options to purchase shares of Common Stock may be granted to certain non-employee directors. The Company’s shareholders ratified the 2004 Directors’ Option Plan at the 2004 Annual Meeting of Shareholders. The Company may grant options to purchase up to 100,000 shares of Common Stock to eligible directors at an exercise price equal to the fair market value as of the grant date. An eligible director will receive an initial option grant to purchase 5,000 shares of Common Stock as of the effective date of his/her appointment or election to the Board of Directors. On each Award Date, defined as August 3, 2004, August 3, 2005 and August 3, 2006, eligible directors are to be granted options to purchase additional shares of Common Stock (to the extent the 2002 Stock Option Plan for Directors did not have enough remaining shares). Stock options granted have terms of ten years and vest over three years from the grant date; however, if there is a Change in Control (as defined in the Hanover Direct, Inc. Directors Change of Control Plan), the participant has the cumulative right to purchase up to 100% of the option shares. Option holders may pay for shares purchased on exercise in cash or Common Stock. The non-employee directors waived their right to the automatic grant of options to be granted on August 3, 2005. As of December 31, 2005 no options have been granted under the 2004 Directors’ Option Plan.

Employment Contracts, Termination of Employment and Change-in-Control Arrangements

Garten Employment Agreement. On May 6, 2004, Wayne P. Garten became the Company’s Chief Executive Officer and President. Mr. Garten is employed pursuant to the terms of a May 6, 2004 Employment Agreement. Under Mr. Garten’s Employment Agreement, he will be paid an annual salary of \$600,000 over a term expiring on May 6, 2006. The Company also granted Mr. Garten options to acquire 200,000 shares of the Company’s common stock, half pursuant to its 2000 Management Stock Option Plan (“2000 Management Option Plan”) and half outside the plan. All of the options have an exercise price of \$1.95 per share, the Common Stock’s average closing price for the ten trading days preceding the grant date and the ten trading days after the grant date. One third of each of the options vested upon execution of the Employment Agreement and the balance will vest in two equal annual installments on the anniversary of the original grant date, subject to earlier vesting in the event of a change in control of the Company (as that term is defined in the Employment Agreement). Mr. Garten is entitled to participate in the Company’s bonus plan for executives, as established by the Board of Directors.

The Employment Agreement provides for a lump sum change in control payment equal to 200% of Mr. Garten’s annual salary if a change in control occurs during the term. The Employment Agreement also provides for eighteen months of severance payments if Mr. Garten is not otherwise entitled to change in control benefits and (i) is terminated without cause or terminates his employment for good reason (as both terms are defined in the Employment Agreement) during the term or (ii) his Employment Agreement is not renewed at the end of the term.

Contino Letter Agreement. Michael Contino, the Company’s Chief Operating Officer, is employed pursuant to a October 29, 2002 letter agreement. Under the letter agreement, Mr. Contino was to receive an annual salary of \$387,000 and is entitled to participate in the Company’s bonus plan for executives, as established by the Board of Directors. Mr. Contino was awarded options to purchase 100,000 shares under the 2000 Management Stock Option Plan. Under the agreement, if Mr. Contino is terminated other than “for cause” or terminates his employment for “good reason” (as those terms are defined in the agreement), he is entitled to eighteen months of severance pay and health benefits. Mr. Contino was a participant in the Company’s eighteen month change in control plan and was entitled to a Transaction Bonus equal to half of his base salary on a change in control. Mr. Contino was paid the Transaction Bonus following the Recapitalization in 2003.

Charles E. Blue had been appointed Chief Financial Officer of the Company effective November 11, 2003. Mr. Blue’s employment with the Company was terminated effective March 8, 2005 and the Company reported in a Current Report on Form 8-K that he had resigned voluntarily. The Company and Mr. Blue were unable to agree on the terms of his voluntary resignation and the Company notified Mr. Blue that his employment had been terminated for cause.

Barsky Letter Agreement. On January 31, 2005, the Company appointed Daniel J. Barsky as its Senior Vice President and General Counsel. Under a letter agreement with the Company, Mr. Barsky will be paid an annual salary of \$265,000 and was granted options to purchase 50,000 shares of Common Stock. One third of the options vested on February 17, 2005 and the balance will vest in two equal annual installments over the next two years on the anniversary of the original grant date, subject to earlier vesting in the event of a change in control of the Company. All of the options have an exercise price of \$1.03 per share, the Common Stock's average closing price for the ten trading days preceding the grant date and the ten trading days after the grant date. Mr. Barsky will be entitled to participate in the Company's bonus plan for executives. The agreement also provides for six months of severance payments if Mr. Barsky is terminated without cause or terminates his employment for good reason. Mr. Barsky was appointed as the Company's Secretary on March 7, 2005.

Swatek Employment Agreement. On April 4, 2005, John W. Swatek became Senior Vice President, Chief Financial Officer and Treasurer of the Company under a March 15, 2005 Employment Agreement. Under the agreement, Mr. Swatek will be paid an annual salary of \$270,000 and was granted options to acquire 50,000 shares of the Company's common stock pursuant to its 2000 Management Stock Option Plan. The options have an exercise price of \$0.81 per share, the Common Stock's average closing price for the ten trading days preceding the grant date and the ten trading days after the grant date. One third of the options vested on execution of the agreement and the balance will vest in two equal annual installments over the next two years on the anniversary of the original grant date, subject to earlier vesting in the event of a change in control of the Company (as that term is defined in the Employment Agreement). The Employment Agreement has a term expiring on May 6, 2006 and provides for a sign-on bonus of up to \$25,000 to the extent his bonus from his prior employer was reduced as a result of his agreeing to join the Company. The Company paid Mr. Swatek \$17,208 under this provision.

The Employment Agreement provides for a lump sum change in control payment equal to Mr. Swatek's annual compensation if his employment is terminated during the term and a change in control occurs during that time. The Employment Agreement also provides for one year's severance if Mr. Swatek is terminated without cause or terminates his employment for good reason (as both terms are defined in the Employment Agreement) during the term and he is not otherwise entitled to change in control benefits. Mr. Swatek will also be entitled to one year of severance payments equal to his annual base salary if his agreement is not renewed at the end of the term.

Compensation Committee Interlocks and Insider Participation

Stuart Feldman, a Compensation Committee member during 2005, is a principal of Chelsey and Chelsey Finance.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Certain Beneficial Owners

The following table lists the beneficial owners known by management of at least 5.0% of the Company's Common Stock or 5.0% of the Company's Series C Preferred as of February 25, 2006. The information is determined in accordance with Rule 13d-3 promulgated under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), based upon information furnished by the persons listed or contained in filings made by them with the Commission. Except as noted below, to the Company's knowledge, each person named in the table will have sole voting and investment power with respect to all shares of Common Stock and Series C Preferred shown as beneficially owned by them.

<u>Title of Class</u>	<u>Name and Address of Beneficial Owner</u>	<u>Amount and Nature of Beneficial Ownership(1)</u>	<u>Percentage of Class(1)</u>
Series C Participating Preferred Stock	Chelsey Direct, LLC, William B. Wachtel and Stuart Feldman c/o Wachtel & Masyr, LLP 152 West 57th Street New York, New York 10019	564,819 (1)	100.0%

Common Stock	Chelsey Direct, LLC, William B. Wachtel and Stuart Feldman c/o Wachtel & Masyr, LLP 152 West 57th Street New York, New York 10019	25,652,472 (2)	76.1%
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- (1) In the case of Common Stock, includes shares of Common Stock issued upon exercise of options or warrants exercisable within 60 days for the subject individual only. Percentages of Common Stock are computed on the basis of 22,426,296 shares of Common Stock outstanding as of February 25, 2006. Percentages of the Series C Preferred are computed on the basis of 564,819 shares of Series C Preferred outstanding as of February 25, 2006.
- (2) According to the Amendment No. 13 to the statement on Schedule 13D filed by Chelsey on March 9, 2006 with the SEC and prior amendments, Chelsey and its related affiliate, Chelsey Finance, is the record holder of 15,364,682 shares of Common Stock, warrants to purchase 10,259,366 shares of Common Stock and 564,819 shares of Series C Preferred. Chelsey Capital Profit Sharing Plan (the “Chelsey Plan”) is the sole member of Chelsey and Mr. Wachtel is the Manager of Chelsey. The sponsor of the Chelsey Plan is DSJ International Resources Ltd. (“DSJI”). Mr. Feldman is the sole officer and director of DSJI and a principal beneficiary of the Chelsey Plan. Mr. Feldman is also the owner of 16,090 shares of Common Stock. Mr. Wachtel, in his capacity as the Manager of Chelsey, has sole voting and dispositive power with respect to 15,364,682 shares of Common Stock and 564,819 shares of Series C Preferred owned by Chelsey, and Mr. Feldman has sole voting and dispositive power with respect to 16,090 shares of Common Stock owned by him. Each of Messrs. Wachtel and Feldman have vested options to purchase 6,167 shares of Common Stock exercisable within 60 days. The shares of Common Stock and Series C Preferred Stock owned by Chelsey and Messrs. Wachtel and Feldman collectively represent approximately 91% of the combined voting power of the Company’s securities (after giving effect to the exercise of all outstanding options and warrants to purchase Common Stock beneficially owned by Chelsey).

Management Ownership

The following table lists share ownership of the Company’s Common Stock and Series C Preferred as of February 25, 2006. The information includes beneficial ownership by (i) each of the Company’s directors and executive officers and (ii) all directors and executive officers as a group. The information is determined in accordance with Rule 13d-3 promulgated under the Exchange Act based upon information furnished by the persons listed or contained in filings made by them with the Commission. Except as noted below, to the Company’s knowledge, each person named in the table will have sole voting and investment power with respect to all shares of Common Stock and Series C Preferred shown as beneficially owned by them.

<u>Name of Beneficial Owner</u>	<u>Amount and Nature of Beneficial Ownership(1)</u>	<u>Percentage of Class(1)</u>
William B. Wachtel	25,630,215 (2)	76.1%
	564,819 (2)	100.0%
A. David Brown.....	9,667 (1)	*
Stuart Feldman.....	25,646,305 (2)	76.1%
	564,819 (2)	100.0%
Paul S. Goodman	4,500 (1)	*
Donald Hecht.....	4,500 (1)	*
Robert H. Masson.....	9,667 (1)	*
Wayne P. Garten.....	138,524 (1)(5)	*
Michael D. Contino	125,240 (1)(6)	*
John W. Swatek.....	33,334 (1)	*
Daniel J. Barsky.....	33,334 (1)	*
Steven Lipner.....	7,000 (1)	*
Directors and Executive Officers as a Group (11 persons).....	26,018,238 (3)	77.2%
	564,819 (4)	100.0%

* Less than one percent

- (1) Represents options to purchase shares of Common Stock exercisable within 60 days.
- (2) According to the Amendment No. 13 to the statement on Schedule 13D filed by Chelsey on March 9, 2006 with the SEC and prior amendments, Chelsey and its related affiliate, Chelsey Finance, is the record holder of 15,364,682 shares of Common Stock, warrants to purchase 10,259,366 shares of Common Stock and 564,819 shares of Series C Preferred. Chelsey Capital Profit Sharing Plan (the "Chelsey Plan") is the sole member of Chelsey and Mr. Wachtel is the Manager of Chelsey. The sponsor of the Chelsey Plan is DSJ International Resources Ltd. ("DSJI"). Mr. Feldman is the sole officer and director of DSJI and a principal beneficiary of the Chelsey Plan. Mr. Feldman is also the owner of 16,090 shares of Common Stock. Mr. Wachtel, in his capacity as the Manager of Chelsey, has sole voting and dispositive power with respect to 15,364,682 shares of Common Stock and 564,819 shares of Series C Preferred owned by Chelsey, and Mr. Feldman has sole voting and dispositive power with respect to 16,090 shares of Common Stock owned by him. Each of Messrs. Wachtel and Feldman have vested options to purchase 6,167 shares of Common Stock exercisable within 60 days. The shares of Common Stock and Series C Preferred Stock owned by Chelsey and Messrs. Wachtel and Feldman collectively represent approximately 91% of the combined voting power of the Company's securities (after giving effect to the exercise of all outstanding options and warrants to purchase Common Stock beneficially owned by Chelsey).
- (3) Shares of Common Stock; includes options to purchase 377,670 shares exercisable within 60 days and warrants to provide 10,259,366 shares of Common Stock.
- (4) Shares of Series C Preferred Stock.
- (5) Includes 190 shares owned by Mr. Garten.
- (6) Includes 240 shares owned by Mr. Contino.

Item 13. *Certain Relationships and Related Transactions*

The Company retained the law firm of Wachtel & Masyr LLP to handle the appeal of the Kaul litigation. Mr. Wachtel, the Company's Chairman and the Manager of Chelsey, is a partner in Wachtel & Masyr. Wachtel & Masyr agreed to handle the appeal for a \$150,000 fixed fee, of which half was incurred and paid in 2004 and the balance was incurred and paid in 2005.

Either the majority of the independent directors of the Company's Board of Directors, a committee of the Company's Board of Directors consisting of independent directors, or, in certain cases, the stockholders have approved these relationships and transactions and, to the extent that such arrangements are available from nonaffiliated parties, all relationships and transactions are on terms no less favorable to the Company than those available from nonaffiliated parties.

Item 14. *Principal Accountants Fees and Services*

Fees and Independence

Prior to their dismissal on October 20, 2005, KPMG provided audit services to the Company consisting of the annual audit of the Company's 2003 consolidated financial statements contained in the Company's Annual Report on Form 10-K for the 2003 fiscal year and reviews of the financial statements contained in the Company's Quarterly Reports on Form 10-Q for the first and second fiscal quarters of 2004 and the three fiscal quarters of 2003. KPMG started but did not complete the audit of the 2004 fiscal year or the review of the third fiscal quarter of 2005. The following table shows the fees that were billed to the Company by KPMG and subsequently paid by the Company for professional services rendered with respect to the fiscal years ended December 25, 2004 and December 27, 2003.

<u>Fee Category</u>	<u>Fiscal Year 2004</u>	<u>% of Total</u>	<u>Fiscal Year 2003</u>	<u>% of Total</u>
Audit Fees(1)(2)	\$ 1,448,000	97.4%	\$ 814,500	84.6%
Audit-Related Fees(3)	38,000	2.6%	133,500	13.9%
Tax Fees(4)	-0-	0%	14,500	1.5%
All Other Fees(5).....	-0-	0%	-0-	0%
Total Fees.....	\$ 1,486,000	100.0%	\$ 962,500	100.0%

The Audit Committee appointed GGK on November 2, 2005 as the Company's principal independent auditors. (KPMG withdrew their opinions for 2002 and 2003 fiscal year end audits as a result of the Restatement.) GGK provided audit services to the Company consisting of the annual audit of the Company's 2004, 2003 and 2002 consolidated financial statements contained in the Company's Annual Report on Form 10-K for 2004 and a review of the financial statements contained in the Company's Quarterly Report on Form 10-Q for the third fiscal quarter of 2004. The following table shows the fees that were billed to the Company by GGK for professional services rendered with respect to the fiscal years ended December 31, 2005, December 25, 2004 and December 27, 2003.

<u>Fee Category</u>	<u>Fiscal Year</u>		<u>Fiscal Year</u>		<u>Fiscal Year</u>	
	<u>2005</u>	<u>% of Total</u>	<u>2004</u>	<u>% of Total</u>	<u>2003</u>	<u>% of Total</u>
Audit Fees(2)	\$395,000	100.0%	\$275,000	100.0%	\$250,000	100.0%
Audit-Related Fees(3).....	-0-	0%	-0-	0%	-0-	0%
Tax Fees(4).....	-0-	0%	-0-	0%	-0-	0%
All Other Fees(5)	-0-	0%	-0-	0%	-0-	0%
Total Fees	\$395,000	100.0%	\$275,000	100.0%	\$250,000	100.0%

Through September 30, 2005, GGK (the "Firm") had a continuing relationship with American Express Tax and Business Services Inc. ("TBS") from which it leased auditing staff who were full time, permanent employees of TBS and through which its partners provided non-audit services. Subsequent to September 30, 2005 this relationship ceased and the Firm established a similar relationship with RSM McGladrey, Inc. ("RSM"). The Firm has no full time employees, and, therefore, none of the audit services performed were provided by permanent, full-time employees of the Firm. The Firm manages and supervises the audit and audit staff and is exclusively responsible for the opinion rendered in connection with its examination.

- (1) Does not include approximately \$516,000 of fees billed by KPMG after their dismissal (approximately \$415,000 relates to the 2004 audit and the remainder relates to quarterly reviews in 2005), a portion of which is in excess of the audit fees previously approved by the Audit Committee. The Company disputes owing KPMG any of the audit fees billed after their dismissal.
- (2) Audit Fees are fees for professional services performed for the audit of the Company's annual financial statements and review of financial statements included in the Company's 10-Q filings, and services that are normally provided in connection with statutory and regulatory filings or engagements. 100% of these fees for fiscal years 2005, 2004 and 2003 were approved by the Audit Committee pursuant to Paragraph (c)(7)(i)(C) of Rule 2-01 of Regulation S-X.
- (3) Audit-Related Fees are fees for assurance and related services that are reasonably related to the performance of the audit or review of the Company's financial statements. This includes: employee benefit and compensation plan audits; due diligence related to mergers and acquisitions; auditor attestations that are not required by statute or regulation; and professional services related to the application of financial accounting / reporting standards. 100% of these fees for fiscal years 2005, 2004 and 2003 were approved by the Audit Committee pursuant to Paragraph (c)(7)(i)(C) of Rule 2-01 of Regulation S-X.
- (4) Tax Fees are fees for professional services performed with respect to tax compliance, tax advice and tax planning. 100% these fees for fiscal years 2005, 2004 and 2003, were approved by the Audit Committee pursuant to Paragraph (c)(7)(i)(C) of Rule 2-01 of Regulation S-X.
- (5) No Other Fees were paid during 2003, 2004 and 2005.

Pre-Approval Policy

The Audit Committee has adopted an audit and non-audit services pre-approval policy, whereby it may pre-approve the provision of services to us by the independent auditors. The policy of the Audit Committee is to pre-approve the audit, audit-related, tax and non-audit services to be performed during the year on an annual basis, in accordance with a schedule of such services approved by the Audit Committee. The annual audit services engagement terms and fees will be subject to the specific pre-approval of the Audit Committee. Audit-related services and tax services to be provided by the auditors will be subject to general pre-approval by the Audit Committee. The Audit Committee may grant specific case-by-case approval for permissible non-audit services. The Audit Committee will establish pre-approval fee levels or budgeted amounts for all services to be provided on an annual basis. Any proposed services exceeding those levels or amounts will require specific pre-approval by the Audit Committee. The Audit Committee has delegated pre-approval authority to the Chairman of the Audit Committee, who will report any such pre-approval decisions to the Audit Committee at its next scheduled meeting.

PART IV

Item 15. Exhibits and Financial Statement Schedules

(a) The following documents are filed as part of this report:

	<u>Page No.</u>
1. Index to Financial Statements	
Report of Independent Registered Public Accounting Firm — Hanover Direct, Inc. and Subsidiaries Financial Statements	34
Consolidated Balance Sheets as of December 31, 2005 and December 25, 2004	35
Consolidated Statements of Income (Loss) for the years ended December 31, 2005, December 25, 2004 and December 27, 2003	36
Consolidated Statements of Cash Flows for the years ended December 31, 2005, December 25, 2004 and December 27, 2003	37
Consolidated Statements of Shareholders' Deficiency for the years ended December 31, 2005, December 25, 2004 and December 27, 2003	39
Selected Quarterly Financial Information (unaudited) for the 13- week fiscal periods ended March 26, 2005, June 25, 2005, September 24, 2005, March 27, 2004, June 26, 2004, September 25, 2004 and December 25, 2004 and for the 14- week fiscal period ended December 31, 2005.	64
2. Index to Financial Statement Schedule	
Schedule II — Valuation and Qualifying Accounts for the years ended December 31, 2005, December 25, 2004 and December 27, 2003	65
Schedules other than that listed above are omitted because they are not applicable or the required information is shown in the financial statements or notes thereto.	
3. Exhibits	
The exhibits required by Item 601 of Regulation S-K filed as part of, or incorporated by reference in, this report are listed in the accompanying Exhibit Index found after the Signature Page.	82

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

Date: March 31, 2006

HANOVER DIRECT, INC.
(Registrant)

By: /s/ Wayne P. Garten
Wayne P. Garten,
President
and Chief Executive Officer
(On behalf of the registrant
and as principal executive officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated and on the date indicated below.

Principal Officers:

By: /s/ John W. Swatek
John W. Swatek,
Senior Vice President, Chief Financial Officer
and Treasurer
(principal financial officer)

By: /s/ Hallie Sturgill
Hallie Sturgill
Vice President and Corporate Controller
(principal accounting officer)

Board of Directors:

/s/ William Wachtel
William Wachtel, Chairman of the Board of
Directors

/s/ Donald Hecht
Donald Hecht, Director

/s/ Robert H. Masson
Robert H. Masson, Director

/s/ Stuart Feldman
Stuart Feldman, Director

/s/ A. David Brown
A. David Brown, Director

/s/ Wayne P. Garten
Wayne P. Garten

/s/ Paul S. Goodman
Paul S. Goodman, Director

Date: March 31, 2006

EXHIBIT INDEX

Exhibit Number
Item 601 of
Regulation S-K

Description of Document and Incorporation by Reference Where Applicable

- 2.1 Stock Purchase Agreement dated as of February 11, 2005 by and among Hanover Direct, Inc., The Company Store Group, LLC and Gump's Holdings, LLC *Incorporated by reference to the Form 8-K filed February 17, 2005.*
- 3.1 Restated Certificate of Incorporation. *Incorporated by reference to the Form 10-K for the year ended December 28, 1996.*
- 3.2 Certificate of Correction filed to correct a certain error in the Restated Certificate of Incorporation. *Incorporated by reference to the Form 10-K for the year ended December 26, 1998.*
- 3.3 Certificate of Amendment to Certificate of Incorporation dated May 28, 1999. *Incorporated by reference to the Form 10-K for the year ended December 25, 1999.*
- 3.4 Certificate of Correction Filed to Correct a Certain Error in the Restated Certificate of Incorporation dated August 26, 1999. *Incorporated by reference to the Form 10-K for the year ended December 25, 1999.*
- 3.5 Certificate of Designations, Powers, Preferences and Rights of Series A Cumulative Participating Preferred Stock. *Incorporated by reference to the Form 8-K filed August 30, 2000.*
- 3.6 Certificate of the Designations, Powers, Preferences and Rights of Series B Participating Preferred Stock. *Incorporated by reference to the Form 8-K filed December 20, 2001.*
- 3.7 Certificate of Elimination of the Series A Cumulative Participating Preferred Stock. *Incorporated by reference to the Form 8-K filed December 20, 2001.*
- 3.8 Certificate of the Designations, Powers, Preferences and Rights of Series C Participating Preferred Stock. *Incorporated by reference to the Form 8-K filed November 30, 2003.*
- 3.9 Certificate of Elimination of the Series B Participating Preferred Stock. *Incorporated by reference to the Form 8-K filed November 30, 2003.*
- 3.10 Certificate of Correction filed on November 26, 2003 with the Delaware Secretary of State to Correct a Certain Error in the Amended and Restated Certificate of Incorporation of Hanover Direct, Inc. filed with the Delaware Secretary of State on October 31, 1996. *Incorporated by reference to the Form 8-K filed November 30, 2003.*
- 3.11 By-laws. *Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 27, 1997.*
- 3.12 Amendment to By-laws. *Incorporated by reference to the Form 8-K filed November 30, 2003.*
- 3.13 Amendment to By-laws. *Incorporated by reference to the Form 10-Q filed August 10, 2004.*
- 3.14 Certificate of the Designations, Powers, Preferences and Rights of Series D Participating Preferred Stock of Hanover Direct, Inc., dated July 8, 2004. *Incorporated by reference to the Form 8-K filed July 12, 2004.*
- 3.15 Certificate of Amendment to Amended and Restated Certificate of Incorporation dated September 22, 2004.
- 3.16 Certificate of Elimination of the Series D Participating Preferred Stock dated September 30, 2004. *Incorporated by reference to the Form 10-Q filed July 12, 2005.*
- 10.12 Hanover Direct, Inc. Key Executive Eighteen Month Compensation Continuation Plan.

**Exhibit Number
Item 601 of
Regulation S-K**

Description of Document and Incorporation by Reference Where Applicable

- Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2001.*
- 10.13 Amendment No. 1 to the Hanover Direct, Inc. Key Executive Eighteen Month Compensation Continuation Plan, dated as of June 1, 2001. *Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2001.*
- 10.14 Amendment No. 2 to the Hanover Direct, Inc. Key Executive Eighteen Month Compensation Continuation Plan, effective as of August 1, 2001. *Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended March 30, 2002.*
- 10.15 Amendment No. 3 to Hanover Direct, Inc. Key Executive Eighteen Month Compensation Continuation Plan, effective October 29, 2003. *Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 27, 2003.*
- 10.16 Hanover Direct, Inc. Key Executive Twelve Month Compensation Continuation Plan. *Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2001.*
- 10.17 Amendment No. 1 to the Hanover Direct, Inc. Key Executive Twelve Month Compensation Continuation Plan, effective as of August 1, 2001. *Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended March 30, 2002.*
- 10.18 Amendment No. 2 to the Hanover Direct, Inc. Key Executive Twelve Month Compensation Continuation Plan, effective as of December 28, 2002. *Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 27, 2003.*
- 10.19 Hanover Direct, Inc. Key Executive Six Month Compensation Continuation Plan. *Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2001.*
- 10.20 Amendment No. 1 to the Hanover Direct, Inc. Key Executive Six Month Compensation Continuation Plan, effective as of August 1, 2001. *Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended March 30, 2002.*
- 10.21 Amendment No. 2 to the Hanover Direct, Inc. Key Executive Six Month Compensation Continuation Plan, effective as of December 28, 2002. *Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 27, 2003.*
- 10.22 Loan and Security Agreement dated as of November 14, 1995 by and among Congress Financial Corporation ("Congress"), HDPA, Brawn, Gump's by Mail, Gump's, The Company Store, Inc. ("The Company Store"), Tweeds, Inc. ("Tweeds"), LWI Holdings, Inc. ("LWI"), Aegis Catalog Corporation ("Aegis"), Hanover Direct Virginia, Inc. ("HDVA") and Hanover Realty Inc. ("Hanover Realty"). *Incorporated by reference to the Form 10-K for the year ended December 30, 1995.*
- 10.23 First Amendment to Loan and Security Agreement dated as of February 22, 1996 by and among Congress, HDPA, Brawn, Gump's by Mail, Gump's, The Company Store, Tweeds, LWI, Aegis, HDVA, Hanover Realty and TAC. *Incorporated by reference to the Form 10-K for the year ended December 28, 1996.*
- 10.24 Second Amendment to Loan and Security Agreement dated as of April 16, 1996 by and among Congress, HDPA, Brawn, Gump's by Mail, Gump's, The Company Store, Tweeds, LWI, Aegis, HDVA, Hanover Realty and TAC. *Incorporated by reference to the Form 10-K for the year ended December 28, 1996.*
- 10.25 Third Amendment to Loan and Security Agreement dated as of May 24, 1996 by and among

**Exhibit Number
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- Congress, HDP, Brawn, Gump's by Mail, Gump's, The Company Store, Tweeds, LWI, Aegis, HDVA, Hanover Realty and TAC. *Incorporated by reference to the Form 10-K for the year ended December 28, 1996.*
- 10.26 Fourth Amendment to Loan and Security Agreement dated as of May 31, 1996 by and among Congress, HDP, Brawn, Gump's by Mail, Gump's, The Company Store, Tweeds, LWI, Aegis, HDVA, Hanover Realty and TAC. *Incorporated by reference to the Form 10-K for the year ended December 28, 1996.*
- 10.27 Fifth Amendment to Loan and Security Agreement dated as of September 11, 1996 by and among Congress, HDP, Brawn, Gump's by Mail, Gump's, The Company Store, Tweeds, LWI, Aegis, HDVA, Hanover Realty and TAC. *Incorporated by reference to the Form 10-K for the year ended December 28, 1996.*
- 10.28 Sixth Amendment to Loan and Security Agreement dated as of December 5, 1996 by and among Congress, HDP, Brawn, Gump's by Mail, Gump's, The Company Store, Tweeds, LWI, Aegis, HDVA, Hanover Realty and TAC. *Incorporated by reference to the Form 10-K for the year ended December 28, 1996.*
- 10.29 Seventh Amendment to Loan and Security Agreement dated as of December 18, 1996 by and among Congress, HDP, Brawn, Gump's by Mail, Gump's, The Company Store, Tweeds, LWI, Aegis, HDVA, Hanover Realty and TAC. *Incorporated by reference to the Form 10-K for the year ended December 28, 1996.*
- 10.30 Eighth Amendment to Loan and Security Agreement dated as of March 26, 1997 by and among Congress, HDP, Brawn, Gump's by Mail, Gump's, The Company Store, Tweeds, LWI, Aegis, HDVA, Hanover Realty and TAC. *Incorporated by reference to the Form 10-K for the year ended December 26, 1998.*
- 10.31 Ninth Amendment to Loan and Security Agreement dated as of April 18, 1997 by and among Congress, HDP, Brawn, Gump's by Mail, Gump's, The Company Store, Tweeds, LWI, Aegis, HDVA, Hanover Realty and TAC. *Incorporated by reference to the Form 10-K for the year ended December 26, 1998.*
- 10.32 Tenth Amendment to Loan and Security Agreement dated as of October 31, 1997 by and among Congress, HDP, Brawn, Gump's by Mail, Gump's, The Company Store, Tweeds, LWI, Aegis, HDVA, Hanover Realty and TAC. *Incorporated by reference to the Form 10-K for the year ended December 26, 1998.*
- 10.33 Eleventh Amendment to Loan and Security Agreement dated as of March 25, 1998 by and among Congress, HDP, Brawn, Gump's by Mail, Gump's, The Company Store, Tweeds, LWI, Aegis, HDVA, Hanover Realty and TAC. *Incorporated by reference to the Form 10-K for the year ended December 26, 1998.*
- 10.34 Twelfth Amendment to Loan and Security Agreement dated as of September 30, 1998 by and among Congress, HDP, Brawn, Gump's by Mail, Gump's, The Company Store, Tweeds, LWI, Aegis, HDVA, Hanover Realty and TAC. *Incorporated by reference to the Form 10-K for the year ended December 25, 1999.*
- 10.35 Thirteenth Amendment to Loan and Security Agreement dated as of September 30, 1998 by and among Congress, HDP, Brawn, Gump's by Mail, Gump's, The Company Store, Tweeds, LWI, Aegis, HDVA, Hanover Realty and TAC. *Incorporated by reference to the Form 10-K for the year ended December 25, 1999.*
- 10.36 Fourteenth Amendment to Loan and Security Agreement dated as of February 28, 2000 by and among Congress, HDP, Brawn, Gump's by Mail, Gump's, The Company Store, Tweeds, LWI, Aegis, HDVA, Hanover Realty and TAC. *Incorporated by reference to the Form 10-K for the year*

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ended December 25, 1999.

- 10.37 Fifteenth Amendment to Loan and Security Agreement dated as of March 24, 2000 by and among Congress, HDP, Brawn, Gump's by Mail, Gump's, LWI, HDVA, Hanover Realty, The Company Store Factory, Inc., The Company Office, Inc., Keystone Internet Services, Inc., Tweeds, LLC, Silhouettes, LLC, Hanover Company Store, LLC and Domestications, LLC. *Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended March 25, 2000.*
- 10.38 Sixteenth Amendment to Loan and Security Agreement dated as of August 8, 2000 by and among Congress, HDP, Brawn, Gump's by Mail, Gump's, LWI, HDVA, Hanover Realty, The Company Store Factory, Inc., The Company Office, Inc., Keystone Internet Services, Inc., Tweeds, LLC, Silhouettes, LLC, Hanover Company Store, LLC and Domestications, LLC. *Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 24, 2000.*
- 10.39 Seventeenth Amendment to Loan and Security Agreement dated as of January 5, 2001 by and among Congress, HDP, Brawn, Gump's by Mail, Gump's, LWI, HDVA, Hanover Realty, The Company Store Factory, Inc., The Company Office, Inc., Keystone Internet Services, Inc., Tweeds, LLC, Silhouettes, LLC, Hanover Company Store, LLC and Domestications, LLC. *Incorporated by reference to the Form 10-K for the year ended December 30, 2000.*
- 10.40 Eighteenth Amendment to Loan and Security Agreement, dated as of November 12, 2001, among Congress, HDP, Brawn, Gump's by Mail, Gump's, LWI, HDVA, Hanover Realty, The Company Store Factory, Inc., The Company Office, Inc., Keystone Internet Services, Inc., Tweeds, LLC, Silhouettes, LLC, Hanover Company Store, LLC and Domestications, LLC. *Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 29, 2001.*
- 10.41 Nineteenth Amendment to Loan and Security Agreement, dated as of December 18, 2001, by and among Congress, HDP, Brawn, Gump's by Mail, Gump's, LWI, HDVA, Hanover Realty, The Company Store Factory, Inc., The Company Office, Inc., Keystone Internet Services, Inc., Tweeds, LLC, Silhouettes, LLC, Hanover Company Store, LLC and Domestications, LLC. *Incorporated by reference to the Form 8-K filed December 20, 2001.*
- 10.42 Twentieth Amendment to Loan and Security Agreement, dated as of March 5, 2002, by and among Congress, HDP, Brawn, Gump's by Mail, Gump's, HDVA, Hanover Realty, The Company Store Factory, Inc., The Company Office, Inc., Keystone Internet Services, Inc., Silhouettes, LLC, Hanover Company Store, LLC and Domestications, LLC. *Incorporated by reference to the Form 10-K for the year ended December 29, 2001.*
- 10.43 Twenty-first Amendment to Loan and Security Agreement, dated as of March 21, 2002, among Congress, HDP, Brawn, Gump's by Mail, Gump's, HDVA, Hanover Realty, The Company Store Factory, Inc., The Company Office, Inc., Keystone Internet Services, Inc., Silhouettes, LLC, Hanover Company Store, LLC and Domestications, LLC. *Incorporated by reference to the Form 10-K for the year ended December 29, 2001.*
- 10.44 Twenty-second Amendment to Loan and Security Agreement, dated as of August 16, 2002, among Congress, HDP, Brawn, Gump's by Mail, Gump's, HDVA, Hanover Realty, The Company Store Factory, Inc., The Company Office, Inc., Silhouettes, LLC, Hanover Company Store, LLC, Domestications, LLC and Keystone Internet Services, Inc. *Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 29, 2002.*
- 10.45 Twenty-third Amendment to Loan and Security Agreement, dated as of December 27, 2002, among Congress, HDP, Brawn, Gump's by Mail, Gump's, HDVA, Hanover Realty, The Company Store Factory, Inc., The Company Office, Inc., Silhouettes, LLC, Hanover Company Store, LLC, Domestications, LLC, Keystone Internet Services, Inc., Keystone Internet Services, LLC and The Company Store Group, LLC. *Incorporated by reference to the Form 10-K for the year ended*

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December 28, 2002.

- 10.46 Twenty-fourth Amendment to Loan and Security Agreement, dated as of February 28, 2003, among Congress, Brawn, Gump's by Mail, Gump's, Hanover Realty, The Company Store Factory, Inc., The Company Office, Inc., Silhouettes, LLC, Hanover Company Store, LLC, Domestications, LLC, Keystone internet Services, LLC and The Company Store Group, LLC. *Incorporated by reference to the Form 10-K for the year ended December 28, 2002.*
- 10.47 Twenty-fifth Amendment to Loan and Security Agreement, dated as of April 21, 2003, among Congress, Brawn, Gump's by Mail, Gump's, Hanover Realty, The Company Store Factory, Inc., The Company Office, Inc., Silhouettes, LLC, Hanover Company Store, LLC, Domestications, LLC, Keystone internet Services, LLC and The Company Store Group, LLC. *Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended March 29, 2003.*
- 10.48 Twenty-sixth Amendment to Loan and Security Agreement, dated as of August 29, 2003, among Congress, Brawn, Gump's by Mail, Gump's, Hanover Realty, The Company Store Factory, Inc., The Company Office, Inc., Silhouettes, LLC, Hanover Company Store, LLC, Domestications, LLC, Keystone internet Services, LLC and The Company Store Group, LLC. *Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 27, 2003.*
- 10.49 Twenty-seventh Amendment to Loan and Security Agreement, dated as of October 31, 2003, among Congress, Brawn, Gump's by Mail, Gump's, Hanover Realty, The Company Store Factory, Inc., The Company Office, Inc., Silhouettes, LLC, Hanover Company Store, LLC, Domestications, LLC, Keystone internet Services, LLC and The Company Store Group, LLC. *Incorporated by reference to the Form 8-K filed October 31, 2003.*
- 10.50 Twenty-eighth Amendment to Loan and Security Agreement, dated as of November 4, 2003, among Congress, Brawn, Gump's by Mail, Gump's, Hanover Realty, The Company Store Factory, Inc., The Company Office, Inc., Silhouettes, LLC, Hanover Company Store, LLC, Domestications, LLC, Keystone internet Services, LLC and The Company Store Group, LLC. *Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 27, 2003.*
- 10.51 Twenty-ninth Amendment to Loan and Security Agreement, dated as of November 25, 2003, among Congress, Brawn, Gump's by Mail, Gump's, Hanover Realty, The Company Store Factory, Inc., The Company Office, Inc., Silhouettes, LLC, Hanover Company Store, LLC, Domestications, LLC, Keystone internet Services, LLC and The Company Store Group, LLC. *Incorporated by reference to the Form 8-K filed November 30, 2003.*
- 10.52 Employment Agreement dated as of September 1, 2002 between Thomas C. Shull and the Company. *Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 29, 2002.*
- 10.53 Amendment No. 1 to Employment Agreement dated as of September 1, 2002 between Thomas C. Shull and the Company. *Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 28, 2002.*
- 10.54 Amendment No. 2 to Employment Agreement dated as of June 23, 2003 between Thomas C. Shull and the Company. *Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 28, 2003.*
- 10.55 Amendment No. 3 to Employment Agreement effective as of August 3, 2003 between Thomas C. Shull and the Company. *Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 28, 2003.*
- 10.56 Final form of letter agreement between the Company and certain Level 8 executive officers.

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- Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 28, 2002.*
- 10.57 Form of Transaction Bonus Letter. *Incorporated by reference to the Form 10-K for the year ended December 28, 2002.*
- 10.58 Hanover Direct, Inc. Savings and Retirement Plan, as amended and restated as of July 1, 1999. *Incorporated by reference to the Form 10-K for the year ended December 29, 2001.*
- 10.59 First Amendment to the Hanover Direct, Inc. Savings and Retirement Plan, effective March 1, 2002. *Incorporated by reference to the Form 10-K for the year ended December 29, 2001.*
- 10.60 Memorandum of Understanding dated November 10, 2003 by and among Hanover Direct, Inc., Chelsey Direct, LLC and Regan Partners, L.P. *Incorporated by reference to the Form 8-K filed November 10, 2003.*
- 10.61 Recapitalization Agreement dated as of November 18, 2003 by and between Hanover Direct, Inc. and Chelsey Direct, LLC. *Incorporated by reference to the Form 8-K filed November 18, 2003.*
- 10.62 Registration Rights Agreement dated as of November 30, 2003 by and among Hanover Direct, Inc., Chelsey Direct, LLC and Stuart Feldman. *Incorporated by reference to the Form 8-K filed November 30, 2003.*
- 10.63 Corporate Governance Agreement dated as of November 30, 2003 by and among Hanover Direct, Inc. Chelsey Direct, LLC, Stuart Feldman, Regan Partners, L.P., Regan International Fund Limited and Basil P. Regan. *Incorporated by reference to the Form 8-K filed November 30, 2003.*
- 10.64 Voting Agreement dated as of November 30, 2003 by and among Chelsey Direct, LLC, Stuart Feldman, Regan Partners, L.P., Regan International Fund Limited and Basil P. Regan. *Incorporated by reference to the Form 8-K filed November 30, 2003.*
- 10.65 General Release dated November 30, 2003 given by Hanover Direct, Inc. and its parents, affiliates, subsidiaries, predecessor firms, shareholders, officers, directors, members, managers, employees, agents and others to Chelsey Direct, LLC and its parents, affiliates, subsidiaries, predecessor firms, shareholders, officers, directors, members, managers, employees, attorneys, agents and others. *Incorporated by reference to the Form 8-K filed November 30, 2003.*
- 10.66 General Release dated November 30, 2003 given by Chelsey Direct, LLC and its parents, affiliates, subsidiaries, predecessor firms, shareholders, officers, directors, members, managers, employees, agents and others to Hanover Direct, Inc. and its parents, affiliates, subsidiaries, predecessor firms, shareholders, officers, directors, members, managers, employees, attorneys, agents and others. *Incorporated by reference to the Form 8-K filed November 30, 2003.*
- 10.67 Stipulation of Discontinuance of the action entitled Hanover Direct, Inc. v. Richemont Finance S.A. and Chelsey Direct, LLC in the Supreme Court of the State of New York, County of New York (Index No. 03/602269) dated November 30, 2003. *Incorporated by reference to the Form 8-K filed November 30, 2003.*
- 10.68 Code of Conduct of the Registrant. *Incorporated by reference to the Form 10-K filed April 9, 2004.*
- 10.69 Thirtieth Amendment to Loan and Security Agreement, dated as of March 25, 2004, among Congress, Brawn, Gump's by Mail, Gump's, Hanover Realty, The Company Store Factory, Inc., The Company Office, Inc., Silhouettes, LLC, Hanover Company Store, LLC, Domestications, LLC, Keystone internet Services, LLC and The Company Store Group, LLC. *Incorporated by reference to the Form 10-K filed April 9, 2004.*
- 10.70 Employment Agreement dated as of May 5, 2004 between Wayne P. Garten and the Company.

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- Incorporated by reference to the Form 10-Q filed August 10, 2004.*
- 10.71 General Release and Covenant Not to Sue, dated as of May 5, 2004, between Thomas C. Shull and the Company. *Incorporated by reference to the Form 10-Q filed August 10, 2004.*
- 10.72 Loan and Security Agreement, dated as of July 8, 2004, among Chelsey Finance, LLC, a Delaware limited liability company, and the Borrowers named therein. *Incorporated by reference to the Form 8-K filed July 12, 2004.*
- 10.73 Intercreditor and Subordination Agreement, dated as of July 8, 2004, between Lender and Congress Financial Corporation, as acknowledged by Borrowers and Guarantors. *Incorporated by reference to the Form 8-K filed July 12, 2004.*
- 10.74 Thirty-first Amendment to Loan and Security Agreement, dated as of July 8, 2004, among Congress Financial Corporation and the Borrowers and Guarantors named therein. *Incorporated by reference to the Form 8-K filed July 12, 2004.*
- 10.75 Series D Preferred Stock Purchase Warrant dated July 8, 2004 issued by Hanover Direct, Inc. to Chelsey Finance, LLC. *Incorporated by reference to the Form 8-K filed July 12, 2004.*
- 10.76 Thirty-Second Amendment to Loan and Security Agreement, dated as of December 30, 2004, among Congress Financial Corporation and the Borrowers and Guarantors named therein. *Incorporated by reference to the Form 8-K filed October 27, 2005.*
- 10.77 Common Stock Purchase Warrant dated September 23, 2004 issued by Hanover Direct, Inc. to Chelsey Finance, LLC.
- 10.78 Thirty-Third Amendment to Loan and Security Agreement, dated as of March 11, 2005, among Congress Financial Corporation and the Borrowers and Guarantors named therein. *Incorporated by reference to the Form 8-K filed October 27, 2005.*
- 10.79 Employment Agreement dated as of March 15, 2005 between John Swatek and the Company. *Incorporated by reference to the Form 8-K filed March 18, 2005.*
- 10.80 Thirty-Fourth Amendment to Loan and Security Agreement, dated as of July 29, 2005, by and among Wachovia Bank, National Association and the Borrowers and Guarantors named therein. *Incorporated by reference to the Form 8-K filed October 27, 2005.*
- 10.81 First Amendment to Loan And Security Agreement dated as of November 30, 2004, by and among Chelsey Finance, LLC and the Borrowers and Guarantors named therein. *Incorporated by reference to the Form 8-K filed October 27, 2005.*
- 10.82 Second Amendment to Loan And Security Agreement dated as of December 30, 2004, by and among Chelsey Finance, LLC and the Borrowers and Guarantors named therein. *Incorporated by reference to the Form 8-K filed October 27, 2005.*
- 10.83 Third Amendment to Loan And Security Agreement dated as of July 29, 2005, by and among Chelsey Finance, LLC and the Borrowers and Guarantors named therein. *Incorporated by reference to the Form 8-K filed October 27, 2005.*
- 10.84 Credit Card Program Agreement between Hanover Direct, Inc. and World Financial Network National Bank dated February 22, 2005. *Incorporated by reference to the Form 8-K filed October 27, 2005.*
- 10.85 Amendment Number One to Credit Card Program Agreement between Hanover Direct, Inc. and World Financial Network National Bank dated March 30, 2005. *Incorporated by reference to the Form 8-K filed October 27, 2005.*

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- 10.86 Agreement between Hanover Direct, Inc. and Encore Marketing International dated March 15, 2006. *Filed with this Form 10-K.*
- 10.87 Thirty-Fifth Amendment to Loan and Security Agreement, dated as of March 28, 2006, by and among Wachovia Bank, National Association and the Borrowers and Guarantors named therein. *Filed with this Form 10-K.*
- 10.88 Fourth Amendment to Loan And Security Agreement dated as of March 28, 2006, by and among Chelsey Finance, LLC and the Borrowers and Guarantors named therein. *Filed with this Form 10-K.*
- 14.1 Hanover Direct, Inc. and Subsidiaries Code of Ethics. *Incorporated by reference to the Form 10-K for the year ended December 28, 2002.*
- 21.1 Subsidiaries of the Registrant.
- 31.1 Certification required by Rule 13a-14(a) or Rule 15d-14(a) signed by Wayne P. Garten.
- 31.2 Certification required by Rule 13a-14(a) or Rule 15d-14(a) signed by John W. Swatek.
- 32.1 Certification required by Rule 13a-14(b) or 15d-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350) signed by Wayne P. Garten.
- 32.2 Certification required by Rule 13a-14(b) or 15d-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350) signed by John W. Swatek.

*Hanover Direct, Inc., a Delaware corporation, is the successor by merger to The Horn & Hardart Company and The Hanover Companies.