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SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

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**FORM 10-Q**

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2008

or

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

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

Commission file number: 000-25867

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**NAUTILUS, INC.**

(Exact name of registrant as specified in its charter)

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**Washington**  
(State or other jurisdiction of  
incorporation or organization)

**94-3002667**  
(I.R.S. Employer  
Identification No.)

**16400 S.E. Nautilus Drive**  
**Vancouver, Washington 98683**  
(Address of principal executive offices, including zip code)

**(360) 859-2900**  
(Registrant's telephone number, including area code)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, 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 ☐ Smaller Reporting Company ☐

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

Number of shares of issuer's common stock outstanding as of October 31, 2008: 30,614,336

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**PART I. FINANCIAL INFORMATION**
**Item 1. Financial Statements**

**NAUTILUS, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(Unaudited, in thousands)

	September 30, 2008	December 31, 2007
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 7,258	\$ 7,911
Trade receivables, net of allowance of \$4,901 and \$4,490, respectively	54,798	88,311
Inventories	50,376	58,910
Prepaid expenses and other current assets	7,864	17,820
Income taxes receivable	11,584	11,382
Assets of discontinued operations	—	73,771
Deferred tax assets	366	18,615
Total current assets	132,246	276,720
Property, plant and equipment, net of accumulated depreciation of \$61,204 and \$59,673, respectively	36,350	42,291
Goodwill	32,579	32,743
Intangible assets, net	36,129	37,917
Other assets	5,800	1,169
Total assets	<u>\$ 243,104</u>	<u>\$ 390,840</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current Liabilities:		
Trade payables	\$ 37,700	\$ 46,918
Accrued liabilities	32,758	37,601
Short-term borrowings	10,458	79,000
Liabilities of discontinued operations	—	15,867
Deferred tax liabilities	1,875	—
Total current liabilities	82,791	179,386
Other long-term liabilities	3,918	6,919
Long-term deferred tax liabilities	8,740	5,123
Income taxes payable	3,047	2,958
Total liabilities	98,496	194,386
Commitments and contingencies (Note 13)		
Stockholders' Equity:		
Common stock – no par value, 75,000 shares authorized, 30,614 and 31,557 shares respectively, issued and outstanding	1,713	4,346
Retained earnings	135,667	185,021
Accumulated other comprehensive income	7,228	7,087
Total stockholders' equity	144,608	196,454
Total liabilities and stockholders' equity	<u>\$ 243,104</u>	<u>\$ 390,840</u>

See notes to consolidated financial statements

**NAUTILUS, INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(Unaudited, in thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Net sales	\$ 93,749	\$115,257	\$318,914	\$354,764
Cost of sales	64,019	71,926	199,325	210,689
Gross profit	29,730	43,331	119,589	144,075
Operation expenses:				
Selling and marketing	29,852	49,872	103,566	138,288
General and administrative	11,011	14,150	45,717	37,036
Research and development	2,243	2,555	6,409	7,981
Litigation settlement	—	—	—	(18,300)
Total operating expenses	43,106	66,577	155,692	165,005
Operating loss	(13,376)	(23,246)	(36,103)	(20,930)
Other income (expense):				
Interest income	38	91	128	244
Interest expense	(169)	(1,606)	(1,499)	(3,357)
Other income (expense), net	(241)	499	(65)	1,023
Total other expense	(372)	(1,016)	(1,436)	(2,090)
Loss from continuing operations before income taxes	(13,748)	(24,262)	(37,539)	(23,020)
Income tax expense (benefit)	21,512	(9,818)	14,236	(9,221)
Loss from continuing operations	(35,260)	(14,444)	(51,775)	(13,799)
Discontinued operations:				
Income from discontinued operations	—	1,900	3,016	6,580
Income tax expense (benefit) from discontinued operations	(1,142)	903	595	2,656
Income from discontinued operations, net of tax	1,142	997	2,421	3,924
Net loss	<u>\$ (34,118)</u>	<u>\$ (13,447)</u>	<u>\$ (49,354)</u>	<u>\$ (9,875)</u>
Loss per share from continuing operations:				
Basic and Diluted	\$ (1.15)	\$ (0.46)	\$ (1.66)	\$ (0.43)
Earnings per share from discontinued operations:				
Basic and Diluted	\$ 0.04	\$ 0.03	\$ 0.08	\$ 0.12
Loss per share:				
Basic and Diluted	\$ (1.11)	\$ (0.43)	\$ (1.58)	\$ (0.31)
Weighted average shares outstanding:				
Basic and Diluted	30,739	31,545	31,285	31,533

See notes to consolidated financial statements.

**NAUTILUS, INC.**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE LOSS**  
(In Thousands)

	<u>Common Stock</u>		<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Income</u>	<u>Total Stockholders' Equity</u>
	<u>Shares</u>	<u>Amount</u>			
BALANCES at JANUARY 1, 2007	31,482	\$ 1,026	\$251,418	\$ 4,190	\$ 256,634
Net loss	—	—	(55,613)	—	(55,613)
Foreign currency translation adjustment	—	—	—	2,897	2,897
Comprehensive loss					(52,716)
Dividends paid \$0.30 per share	—	—	(9,465)	—	(9,465)
Cumulative change from adoption of FIN 48	—	—	(1,319)	—	(1,319)
Share-based compensation expense	—	2,679	—	—	2,679
Restricted stock released	12	—	—	—	—
Options exercised	63	756	—	—	756
Stock option income tax deficiencies	—	(115)	—	—	(115)
BALANCES at DECEMBER 31, 2007	31,557	4,346	185,021	7,087	196,454
Net loss	—	—	(49,354)	—	(49,354)
Foreign currency translation adjustment	—	—	—	141	141
Comprehensive loss					(49,213)
Share-based compensation expense	—	2,932	—	—	2,932
Options exercised	90	563	—	—	563
Stock purchases	(1,033)	(5,320)	—	—	(5,320)
Stock option income tax deficiencies	—	(808)	—	—	(808)
BALANCES at SEPTEMBER 30, 2008	<u>30,614</u>	<u>\$ 1,713</u>	<u>\$135,667</u>	<u>\$ 7,228</u>	<u>\$ 144,608</u>

See notes to consolidated financial statements.

**NAUTILUS, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Unaudited, in thousands)

	Nine Months Ended September 30,	
	2008	2007
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net loss	\$ (49,354)	\$ (9,875)
Income from discontinued operations	2,421	3,924
Loss from continuing operations	(51,775)	(13,799)
Adjustments to reconcile loss from continuing operations to net cash provided by operating activities		
Depreciation and amortization	11,609	11,103
Share-based compensation expense	2,932	2,192
Provision for long-term receivables	—	4,770
(Gain) loss on sale of property, plant and equipment	68	(19)
Loss on sale of assets held for sale	439	—
Excess tax benefit from exercise of employee stock options	—	(111)
Deferred income taxes	22,927	(4,390)
Litigation settlement	—	(18,300)
Foreign currency transaction gain	(107)	(822)
Changes in assets and liabilities:		
Trade receivables	34,032	56,386
Inventories	8,772	(14,418)
Prepaid expenses and other assets	830	8,642
Income taxes	(247)	(9,909)
Trade payables	(9,230)	(12,597)
Accrued liabilities	(7,237)	(2,663)
Net cash provided by operating activities of continuing operations	13,013	6,065
Net cash provided by (used in) operating activities of discontinued operations	(1,617)	2,514
Net cash provided by operating activities	11,396	8,579
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of property, plant and equipment	(4,373)	(8,815)
Proceeds from sale of property, plant and equipment	141	32
Proceeds from sale of assets held for sale	1,238	—
Refund of acquisition escrow deposit	5,000	—
Net increase in other intangibles and other assets	(285)	(35,024)
Net (increase) decrease in short-term note receivable	2,384	(101)
Net cash provided by (used in) investing activities from continuing operations	4,105	(43,908)
Net cash provided by (used in) investing activities from discontinued operations	58,411	(845)
Net cash provided by (used in) investing activities	62,516	(44,753)

(continued)

**NAUTILUS, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Unaudited, in thousands)

	<b>Nine Months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Cash dividends paid on common stock	—	(9,465)
Proceeds from exercise of stock options	563	756
Excess tax benefit from exercise of employee stock options	—	111
Net (reduction) increase in short-term borrowings	(68,542)	61,500
Stock repurchases	(5,320)	—
Net cash provided by (used in) financing activities from continuing operations	(73,299)	52,902
Net cash used in financing activities from discontinued operations	(174)	(142)
Net cash provided by (used in) financing activities	(73,473)	52,760
Net effect of foreign currency exchange rate changes	(1,092)	448
Net (decrease) increase in cash and cash equivalents	(653)	17,034
Cash and cash equivalents, beginning of period	7,911	4,262
Cash and cash equivalents, end of period	<u>\$ 7,258</u>	<u>\$21,296</u>
Supplemental disclosures:		
Cash paid for interest	<u>\$ 2,474</u>	<u>\$ 2,944</u>
Cash refunded (paid) for income taxes	<u>\$ 8,652</u>	<u>\$ (8,454)</u>
<b>SUPPLEMENTAL DISCLOSURE OF OTHER NONCASH INVESTING AND FINANCING ACTIVITIES:</b>		
Escrow deposit included in other assets for sale of Pearl Izumi	\$ 4,365	—
Intangible assets received from Litigation Settlement	—	\$18,300

(concluded)

See notes to consolidated financial statements.

**NAUTILUS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**1. BASIS OF PRESENTATION**

The accompanying consolidated financial statements relate to Nautilus, Inc. and its subsidiaries (the “Company”) as of September 30, 2008 and for the three and nine month periods ended September 30, 2008 and 2007. All intercompany transactions and balances have been eliminated in consolidation.

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. These financial statements should be read in conjunction with the audited financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2007.

The financial information included herein reflects all adjustments of a normal recurring nature which are, in the opinion of management, necessary for a fair presentation of the results for the interim periods presented. The results of operations for the three and nine month periods ended September 30, 2008 are not necessarily indicative of the results to be expected for the full year.

On April 18, 2008, the Company completed the sale of its former fitness apparel business, DashAmerica, Inc. d/b/a PearlIzumI (“Pearl Izumi”). Accordingly, all assets and liabilities and results of operations associated with the fitness apparel business have been presented in the consolidated financial statements as discontinued operations separate from continuing operations.

**Use of Accounting Estimates**

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses and the disclosure of contingent assets and liabilities in the financial statements. Actual results could differ from those estimates. Some of these more significant estimates relate to revenue recognition, allowance for doubtful accounts, inventory, product warranty, share based compensation, litigation and loss contingencies, goodwill and intangible assets and income taxes.

**Reclassifications**

At December 31, 2007, we revised our prior presentation of royalty expense which was presented as a separate line within operating expenses. For all periods presented, we now report royalty expenses related to items manufactured and sold in cost of sales. Expenses incurred for preproduction royalties are included in research and development expense. Preproduction royalties represent costs incurred to utilize licensed patent technologies prior to a product being available for manufacture and sale. These misstatements did not materially impact any previously issued financial statements. However, in order to present such information on a consistent basis we have revised prior period comparative information presented herein.

Certain other immaterial reclassifications of amounts reported in the prior period financial statements have been made to conform to classifications used in the current period financial statements.

**Goodwill and Intangible Assets**

***Goodwill and Intangible Assets*** – Goodwill and intangible assets primarily consist of license agreements, patents, trademarks and goodwill. Goodwill and intangible assets deemed to have indefinite lives are not amortized but are subject to annual impairment tests or when impairment indicators exist in accordance with Statement of Financial Accounting Standards (“SFAS”) No. 142, *Goodwill and Other Intangible Assets*, (“SFAS No. 142”). Intangible assets that are deemed to have finite lives are amortized using the straight-line method over their estimated useful lives.

***Impairment of Long-lived and Intangible Assets*** – Long-lived and intangible assets that are determined to have finite lives are measured for impairment in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, when events or circumstances indicate the carrying value may be impaired. In these cases, the Company estimates the future undiscounted cash flows to be derived from the asset to determine whether a potential impairment exists. If the carrying value exceeds the estimate of future undiscounted cash flows, the Company then calculates the amount of impairment charge as the excess of the carrying value of the asset over the estimate of its fair value.

The Company tests goodwill and indefinite-lived intangible assets for impairment annually, in the fourth quarter of each year or when events or changes in circumstances indicate that the carrying amount of such assets may be impaired, using the two-step process prescribed in SFAS No. 142. The first step is a screen for potential impairment, while the second step measures the amount of the impairment, if any.



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In the second quarter of 2008, the Company began reorganizing its internal structure to establish teams with authority and responsibility for the operations of the global direct, commercial and retail business units as well as the corporate functions. Each business unit is focusing on improving shareholder return with a particular focus currently on operating effectiveness and costs, market position and product innovation. As a result of the changes in the internal organization, the Company has changed its reportable segments and reports direct, commercial and retail businesses and the corporate functions.

As a result of the reorganization, the Company was required under SFAS No. 142 to assign goodwill to the new reportable segments and determine if goodwill was impaired. As of June 30, 2008, of the total goodwill of \$32.7 million previously assigned to the Fitness Equipment Business, the Company assigned \$29.8 million to the retail business and \$2.9 million to the direct business. Goodwill was assigned on the basis of the original acquisition that generated the goodwill. The Company acquired the assets of Schwinn Fitness in 2001 which generated \$29.8 million in goodwill and then acquired Nautilus Fitness Canada in 2005 which generated \$2.9 million in goodwill. Schwinn Fitness is primarily a retail brand. Nautilus Fitness Canada was acquired for the direct business. Based on the Company's updated evaluation, goodwill was not impaired at June 30, 2008.

The Company will complete a full analysis of impairment for goodwill and other intangible assets during the fourth quarter of 2008. Current market conditions, including a declining market capitalization, declining sales and accumulating operating losses may be indicators that goodwill and other intangible assets are impaired. Although our current analysis did not result in impairment charges during the third quarter of 2008, further changes in economic and market conditions may have an impact on the analysis which may result in the Company recording impairment charges in the future.

### **Product Warranty**

The Company's products carry limited warranty provisions for defects in materials and workmanship. A warranty reserve is established at the time of sale to cover estimated costs based on the Company's history of warranty repair costs and is recorded in cost of sales. The Company's warranty costs include the cost to manufacture or purchase warranty parts from suppliers as well as the related cost to ship those parts to customers and, for commercial products, the cost of labor to replace the warranty part. A summary of accrued warranties is as follows:

<u>(in thousands)</u>	<u>Three months ended</u> <u>September 30,</u>		<u>Nine months ended</u> <u>September 30,</u>	
	<u>2008</u>	<u>2007</u>	<u>2008</u>	<u>2007</u>
Balance at beginning of period	\$21,556	\$ 8,370	\$ 25,185	\$ 9,699
Charged to costs and expenses	2,045	3,107	7,245	7,016
Claims paid	(3,797)	(3,104)	(12,626)	(8,342)
Balance at end of period	<u>\$19,804</u>	<u>\$ 8,373</u>	<u>\$ 19,804</u>	<u>\$ 8,373</u>

Warranty reserves of \$3.6 million and \$6.9 million are classified as non-current liabilities at September 30, 2008 and December 31, 2007, respectively.

### **Related Party Transactions**

The Company's largest shareholder, Sherborne Investors LP ("Sherborne") undertook a successful proxy contest to replace four of the Company's directors with its nominees in a December 2007 special meeting of shareholders. In May 2008, shareholders approved the reimbursement of up to \$560,000 of expenses incurred by Sherborne in connection with the proxy contest. Payment will be made upon approval of the disinterested members of the Company's Board of Directors which is anticipated after the Company returns to profitability. This is recorded as an accrued liability at September 30, 2008.

### **New Accounting Pronouncements**

In May 2008, the Financial Accounting Standards Board ("FASB") issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles* ("SFAS No. 162"). This Statement identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of entities that are presented in conformity with generally accepted accounting principles (the GAAP hierarchy). SFAS No. 162 will become effective 60 days following the Securities and Exchange Commission's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*. The Company does not expect the adoption of SFAS No. 162 to have a material effect on its consolidated financial position, results of operations or cash flows.

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In March 2008, the FASB issued SFAS No. 161, *Disclosures About Derivative Instruments and Hedging Activities* (“SFAS No. 161”). This Statement is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity’s financial position, financial performance and cash flows. The provisions of SFAS No. 161 are effective for the fiscal years and interim quarters beginning after November 15, 2008. The Company does not expect the adoption of this statement to have a material effect on its consolidated financial position, results of operations or cash flows.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of Accounting Research Bulletin No. 51* (“SFAS No. 160”). SFAS No. 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent’s ownership interest, and the valuation of retained, noncontrolling equity investments when a subsidiary is deconsolidated. SFAS No. 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS No. 160 is effective for fiscal years beginning after December 15, 2008. The Company does not expect the adoption of this statement to have a material effect on its consolidated financial position, results of operations or cash flows.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (“SFAS No. 159”), which gives entities the option to measure eligible financial assets, and financial liabilities at fair value on an instrument by instrument basis, that are otherwise not permitted to be accounted for at fair value under other accounting standards. The election to use the fair value option is available when an entity first recognizes a financial asset or financial liability. Subsequent changes in fair value must be recorded in earnings. This statement was effective as of January 1, 2008, and had no impact on the Company’s consolidated financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (“SFAS No. 157”). This statement defines fair value, establishes a framework for measuring fair value in U.S. GAAP, and expands disclosures about fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and had no impact on the Company’s consolidated financial position, results of operations or cash flows.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* (“SFAS No. 141(R)”), which establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree, and the goodwill acquired. SFAS No. 141(R) also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS No. 141(R) is effective for fiscal years beginning after December 15, 2008. The Company does not expect the adoption of this statement to have a material effect on its consolidated financial position, results of operations or cash flows.

## 2. DISCONTINUED OPERATIONS

The Company completed the sale of Pearl Izumi on April 18, 2008 for aggregate consideration of \$69.4 million, including assumption of \$4.1 million in debt, received net cash proceeds of \$58.4 million and \$4.4 million in an escrow account reflected in other assets. The assets, liabilities and results of operations of the fitness apparel division have been presented separately in the consolidated financial statements as discontinued operations.

Revenues, income before income taxes, income tax expense (benefit) and income from discontinued operations were as follows:

(in thousands)	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Revenue	\$ —	\$18,379	\$27,616	\$54,784
Income before income taxes	\$ —	\$ 1,900	\$ 3,016	\$ 6,580
Income tax expense (benefit)	(1,142)	903	595	2,656
Income from discontinued operations	\$ 1,142	\$ 997	\$ 2,421	\$ 3,924

The Company adjusted the carrying value of the net assets of Pearl Izumi to the net sales proceeds from the sale which resulted in a pre-tax impairment charge of \$1.3 million for the nine months ended September 30, 2008. No costs associated with exit or disposal activities as contemplated by SFAS No. 146 *Accounting for Costs Associated with Exit or Disposal Activities* have been recorded for the sale of Pearl Izumi.

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The Company recorded an income tax benefit from discontinued operations of \$1.1 million during the quarter ended September 30, 2008 as a result of changes in the Company's consolidated taxes and an increase in the Company's annual estimated loss from continuing operations.

Assets and liabilities of the fitness apparel division have been segregated and presented as assets and liabilities of discontinued operations in the consolidated balance sheets for all periods presented. Depreciation and amortization related to assets held for sale ceased as of December 15, 2007. Assets and liabilities for the discontinued operations were zero at September 30, 2008 and as follows at December 31, 2007:

<u>(in thousands)</u>	<u>December 31, 2007</u>
Current assets	\$ 28,660
Property and equipment, net	1,411
Goodwill	19,743
Intangible and other assets	23,957
Assets of discontinued operations	<u>\$ 73,771</u>
Current liabilities	\$ 5,779
Long-term debt excluding current portion	3,797
Noncurrent deferred tax liabilities	6,291
Liabilities of discontinued operations	<u>\$ 15,867</u>

### 3. RESTRUCTURING ACTIVITIES

In 2008, the Company began an initiative to improve profitability including the establishment of separate responsibility for the leadership of each business. As a result, the Company has reorganized by business unit, including global commercial, retail and direct. The restructuring initiatives have included staffing reductions, closing its Australian direct sales operations in January 2008, closing its Canadian call center in March of 2008 and closing its Illinois distribution center in May of 2008.

In July 2008, the Company announced plans to consolidate its manufacturing and distribution facilities. The Company expects to close its Tulsa, Oklahoma facilities by the end of 2008. The Tulsa operations will primarily be moved to existing facilities in Independence, Virginia and Portland, Oregon.

The nature of the costs incurred under the Company's restructuring plans include:

- Employee termination and other employee costs
- Lease termination and facilities related costs
- Inventory writedowns

Following is a summary of expenses associated with the restructuring activities:

<u>(in thousands)</u>	<u>Three months ended September 30, 2008</u>	<u>Nine months ended September 30, 2008</u>
Employee termination and other employee costs	\$ 532	\$ 4,794
Lease termination and facilities related costs	285	619
Current asset write-downs	1,936	1,936
Total restructuring charges	<u>\$ 2,753</u>	<u>\$ 7,349</u>

Restructuring charges were included in the operating results for each reportable segment including \$70,000 in corporate and \$2.7 million in commercial for the quarter ended September 30, 2008. For the nine months ended September 30, 2008, restructuring charges for each reportable segment were \$4.2 million in corporate, \$0.4 million in direct, \$40,000 in retail and \$2.8 million in commercial.

The Company anticipates that it will incur additional restructuring costs of \$4.6 million through the first quarter of 2009 relating to the Tulsa closure. The anticipated charges for the Tulsa closure are estimated to include \$1.0 million for employee termination costs, \$1.7 million for lease termination and facilities related costs and \$1.9 million of asset write-downs and other costs. Management is continuing its strategic review of global operations which may result in additional restructuring costs which have not yet been determined.

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The following table summarizes activity associated with the Company's restructuring plans included in accrued liabilities on the balance sheet.

<i>(in thousands)</i>	Severance and Benefits	Facilities	Accrued Liability
Balance as of January 1, 2008	\$ —	\$ —	\$ —
Accruals	4,794	624	5,418
Payments	(1,461)	(450)	(1,911)
Non-cash charges	(1,263)	—	(1,263)
Balance as of September 30, 2008	<u>\$ 2,070</u>	<u>\$ 174</u>	<u>\$ 2,244</u>

Restructuring liabilities due within one year of the balance sheet date are classified as accrued liabilities. Long-term liabilities included in the table above are \$0.3 million at September 30, 2008.

## 4. STOCKHOLDERS' EQUITY

### Stock Options

A summary of the Company's stock option plan activity for the nine months ended September 30, 2008 is as follows:

<i>(in thousands, except exercise price)</i>	Total Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Outstanding at January 1, 2008	2,804	\$ 13.54		
Granted	1,003	4.33		
Forfeited or cancelled	(599)	11.28		
Expired	(631)	11.97		
Exercised	(90)	6.26		\$ 34
Outstanding at September 30, 2008	<u>2,488</u>	<u>\$ 11.03</u>	<u>4.27</u>	<u>\$ 240</u>
Vested and expected to vest at September 30, 2008	<u>1,970</u>	<u>\$ 11.97</u>	<u>3.81</u>	<u>\$ 136</u>
Exercisable at September 30, 2008	<u>1,215</u>	<u>\$ 13.67</u>	<u>2.53</u>	<u>\$ 0</u>

The fair value of the Company's equity awards was estimated utilizing the following assumptions:

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Expected life (years)	4.6	4.8	4.6	4.8
Risk-free interest rate	3.2%	4.6%	3.2%	4.7%
Expected dividend yield	0%	3.9%	0%	3.1%
Expected volatility	51%	44%	51%	44%

Share based compensation expense for stock options for the three and nine months ended September 30, 2008 was \$0.8 million and \$2.5 million, respectively compared to \$0.7 million and \$2.1 million for the three and nine months ended September 30, 2007. The weighted average grant-date fair value of stock options granted during the nine month periods ended September 30, 2008 and 2007 was \$1.96 and \$5.26, respectively for stock options granted. Unrecognized costs related to stock options totaled approximately \$3.5 million at September 30, 2008 and are expected to be recognized over a weighted average period of 2.46 years.

During the first quarter of 2008, the Company was contractually obligated to accelerate vesting of certain stock options related to the termination of the former Chief Executive Officer and incurred \$1.0 million of share based compensation charges which are recorded in general and administrative expenses.

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In the fourth quarter of 2007, the Board of Directors suspended the payment of quarterly dividends. Payment of any future dividends is at the discretion of our Board of Directors, which considers various factors such as our financial condition, operating results, current and anticipated cash needs and future expansion plans. The Company's loan agreement contains covenants that include limitations on paying dividends when certain ratios are not met. Based on the covenants, the Company is currently precluded from paying dividends.

### Restricted Stock

A summary of the Company's restricted stock activity is as follows:

<u>(in thousands, except fair value amounts)</u>	<u>Number of Shares</u>	<u>Weighted Average Grant Date Fair Value</u>
Outstanding at January 1, 2008	266	\$ 9.23
Awarded	—	—
Vested	—	—
Forfeited	(108)	9.23
Outstanding at September 30, 2008 (1)	158	\$ 9.23

(1) Outstanding awards of restricted stock are all nonvested at September 30, 2008.

Service-based restricted stock is granted at no cost to key employees and generally vests over two years from the date of grant. The fair value of service-based restricted stock was determined based on the number of units granted and the closing price of the Company's common stock on the date of the grant.

Restricted stock compensation expense for the three and nine months ended September 30, 2008 was \$0.1 million and \$0.4 million, respectively, compared to \$0.1 million for the three and nine months ended September 30, 2007. Unrecognized costs related to restricted stock totaled approximately \$0.5 million at September 30, 2008 and are expected to be recognized over a weighted average period of 0.87 years. At September 30, 2008 and 2007, the restricted stock had an intrinsic value of \$0.7 million and \$2.3 million, respectively.

### Performance Units

The Company has 34,000 performance units outstanding with a weighted average grant date fair value of \$15.62 at September 30, 2008 compared to 48,000 performance units outstanding with a weighted average grant date fair value of \$15.68 at December 31, 2007. The performance units vest if the Company meets certain earnings per share targets set by the Compensation Committee of the Board of Directors through December 31, 2009. None of the performance units were vested at September 30, 2008 and December 31, 2007. Compensation expense has not been recognized for the performance units as it is unlikely the performance targets that trigger vesting will be met. At September 30, 2008 there was approximately \$0.5 million of total unrecognized compensation cost related to the performance units.

## **5. INVENTORIES**

Inventories consisted of the following:

<u>(in thousands)</u>	<u>September 30, 2008</u>	<u>December 31, 2007</u>
Finished goods	\$ 34,970	\$ 39,143
Work-in-process	1,438	1,261
Parts and components	6,695	8,422
Raw materials	7,273	10,084
Inventories	\$ 50,376	\$ 58,910

Inventories are stated at the lower of cost or market. The Company evaluates the need for inventory valuation adjustments associated with obsolete, slow-moving and not saleable inventory by reviewing current transactions and forecasted product demand on a monthly basis.

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## 6. OTHER INTANGIBLES ASSETS

Intangible assets, exclusive of goodwill, consisted of the following:

<i>(in thousands)</i>	Estimated Useful Life (in years)	September 30, 2008	December 31, 2007
Intangible assets:			
Indefinite life trademarks	N/A	\$ 17,519	\$ 17,519
Patents	1 to 16	23,209	23,007
Non-compete agreement	3	—	1,957
Total intangible assets		40,728	42,483
Accumulated amortization:			
Patents		(4,599)	(2,826)
Non-compete agreements		—	(1,740)
Total accumulated amortization		(4,599)	(4,566)
Intangible assets, net		\$ 36,129	\$ 37,917

Identifiable intangible assets such as license agreements, patents, and trademarks are recorded at cost, or when acquired as part of a business combination, at estimated fair value and are amortized straight-line over the period they are expected to provide the Company with economic benefit. The amortization expense for the next five full succeeding years is estimated at \$2.5 million each year.

## 7. ACCRUED LIABILITIES

Accrued liabilities consisted of the following:

<i>(in thousands)</i>	September 30, 2008	December 31, 2007
Restructuring accruals	\$ 1,935	\$ —
Warranty reserve, current portion	16,194	18,266
Payroll and benefit accruals	4,826	7,052
Sales returns reserves	1,131	1,634
Royalty accruals	1,990	1,537
Related party payable	560	—
Other	6,122	9,112
Accrued liabilities	\$ 32,758	\$ 37,601

## 8. LINE OF CREDIT AND OTHER DEBT

On January 16, 2008 the Company and its subsidiary Nautilus International S.A. entered into a Loan and Security Agreement (the “Loan Agreement”) with Bank of America N.A., as agent for the lenders who were party thereto. The Loan Agreement, as amended, provides for a \$40 million revolving secured credit line. The Loan Agreement is available for letters of credit, working capital and general business purposes, including acquisition financing. The Loan Agreement contains minimum Earnings Before Interest, Tax, Depreciation and Amortization (“EBITDA”) covenants excluding certain agreed upon non-cash charges and unusual expense items from the calculation of EBITDA. The Loan Agreement, as amended, contains a provision to increase the loan amount to \$65 million under certain circumstances. At September 30, 2008, the Company had borrowings of \$10.5 million outstanding on the Loan Agreement. The interest rate under the Loan Agreement is either prime rate plus zero to 75 basis points or LIBOR plus 150 to 325 basis points depending on the Company’s fixed charge coverage ratio. The use of prime or LIBOR is at the discretion of management. The interest rate on the Company’s outstanding borrowings at September 30, 2008 was 5.5%.

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The Company completed the sale of Pearl Izumi on April 18, 2008 and received net cash proceeds of \$58.4 million. Upon receipt of these proceeds, the Company paid off all amounts then outstanding under the Loan Agreement, as required by the Loan Agreement.

On May 5, 2008, the Company entered into a Third Amendment to the Loan Agreement (“Third Amendment”). Pursuant to the Third Amendment, the lender consented to the repurchase by the Company of up to \$10.0 million of its common stock.

On August 27, 2008, the Company entered into a Fourth Amendment to the Loan Agreement (“Fourth Amendment”). The Fourth Amendment reduces the aggregate borrowings under the agreement from \$70 million to \$40 million to better match the Company’s anticipated borrowing needs.

### 9. COMPREHENSIVE LOSS

Accounts of the Company’s foreign operations are measured using the local currency as the functional currency. These accounts are then translated into U.S. dollars using the current rate method with translation gains and losses accumulated as the comprehensive income (loss) component of stockholders’ equity. Transaction gains or losses incurred by conducting business in other currencies are recorded as part of other income/expense in the Consolidated Statements of Operations.

Comprehensive loss was as follows:

<u>(in thousands)</u>	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Net loss	<u>\$ (34,418)</u>	<u>\$ (13,447)</u>	<u>\$ (49,354)</u>	<u>\$ (9,875)</u>
Foreign currency translation adjustments	<u>(1,348)</u>	<u>1,414</u>	<u>141</u>	<u>2,279</u>
Comprehensive loss	<u><u>\$ (35,766)</u></u>	<u><u>\$ (12,033)</u></u>	<u><u>\$ (49,213)</u></u>	<u><u>\$ (7,596)</u></u>

### 10. STOCK REPURCHASE PROGRAM

In May 2008, the Company’s Board of Directors authorized the repurchase of up to \$10 million of the Company’s common stock in open-market transactions, at times and in such amounts as management deems appropriate, depending on market conditions and other factors. The authorization continues until such date as the Board of Directors shall terminate such authorization; provided, the aggregate amount spent on such repurchases does not exceed \$10 million. The repurchase program does not obligate the Company to acquire any specific number of shares or acquire shares over any specified period of time. The Company repurchased 618,068 shares and 1,032,800 shares for \$3.1 million and \$5.3 million during the three and nine months ended September 30, 2008, respectively.

### 11. INCOME TAXES

The Company recognized an income tax provision for both the three and nine months ended September 30, 2008, despite losses before taxes for each of the periods. The provision is primarily due to uncertainty concerning the realization of certain net deferred tax assets, as prescribed by SFAS No. 109, “*Accounting for Income Taxes*.” A valuation allowance of \$26.8 million was recorded during the third quarter of 2008 to reduce certain net deferred tax assets to their anticipated realizable value. The remaining value was determined by evaluating the potential to recover the value of these assets through certain tax planning strategies.

## 12. LOSS PER SHARE

SFAS No. 128 *Earnings per Share* requires dual presentation of basic and diluted earnings per share (“EPS”). Basic EPS is based on the weighted average number of common shares outstanding. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. For the calculation of diluted EPS, the basic number of weighted average shares is increased by the dilutive effect of stock options and restricted stock determined using the treasury stock method. The calculation of the number of weighted average shares outstanding is as follows:

<i>(in thousands, except per share amounts)</i>	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Basic weighted average shares outstanding	30,739	31,545	31,285	31,533
Dilutive effect of stock options and restricted stock	—	—	—	—
Diluted weighted average shares outstanding	30,739	31,545	31,285	31,533
Loss from continuing operations	<u>\$ (35,260)</u>	<u>\$ (14,444)</u>	<u>\$ (51,775)</u>	<u>\$ (13,799)</u>
Loss per share from continuing operations:				
Basic	\$ (1.15)	\$ (0.46)	\$ (1.66)	\$ (0.43)
Diluted	<u>\$ (1.15)</u>	<u>\$ (0.46)</u>	<u>\$ (1.66)</u>	<u>\$ (0.43)</u>

During the three and nine months ended September 30, 2008, there were 2,366,000 and 2,882,000 weighted average shares of stock options, respectively, for which the exercise price was higher than the market price of the Company’s shares for the periods. These options were not included in the computation of diluted loss per share because the effect would have been antidilutive. This compares to 2,518,000 and 1,794,000 weighted average shares outstanding anti-dilutive options that were excluded from the corresponding periods ended September 30, 2007. As common stock equivalents have an anti-dilutive effect on the net loss from continuing operations, the equivalents were not included in the computation of diluted loss per share for the three and nine months ended September 30, 2008 and 2007.

During the three and nine months ended September 30, 2008, there were 67,000 and 55,000 weighted average shares of restricted stock that were not included in the computation of diluted loss per share because the effect would have been anti-dilutive. This compares to 8,000 and 11,000 weighted average shares outstanding of restricted stock that were excluded from the corresponding periods ended September 30, 2007. As common stock equivalents have an anti-dilutive effect on the loss from continuing operations, the equivalents were not included in the computation of diluted loss per share for the three and nine months ended September 30, 2008 and 2007.

## 13. COMMITMENTS AND CONTINGENCIES

### Legal Matters

The Company is involved in various claims, lawsuits and other proceedings from time to time. Such litigation involves uncertainty as to possible losses the Company may ultimately realize when one or more future events occur or fail to occur. We accrue and charge to income estimated losses from contingencies when it is probable that a liability had been incurred and the amount of loss can be reasonably estimated. Differences between estimates recorded and actual amounts determined in subsequent periods are treated as changes in accounting estimates. The Company estimates the probability of losses on legal contingencies based on the advice of internal and external counsels, outcomes from similar litigation, the status of the lawsuits (including settlement initiatives), legislative developments, and other factors. Due to numerous variables associated with these judgments and assumptions, both the precision and reliability of the resulting estimates of the related loss contingencies are subject to substantial uncertainties. The Company regularly monitors its estimated exposure to these contingencies and, as additional information becomes known, may change its estimates significantly. A significant change in the estimates, or a result that materially differs from the estimates, could have a significant impact on the Company’s financial position, results of operations and cash flows.

### *Salomon*

In connection with the sale of Pearl Izumi to Shimano American Corporation, the Company agreed to indemnify Shimano American Corporation in connection with a lawsuit filed by Salomon S.A. against Pearl Izumi arising out of a claim of alleged patent infringement regarding the use of ventilated fabric in certain shoes manufactured by Pearl Izumi. The lawsuit was filed in Mannheim, Germany and the relief sought by Salomon includes monetary damages and injunctive relief. The Company does not expect to incur material liability related to this lawsuit.



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### *BioSig*

In 2004 the Company was sued in the Southern District of New York by BioSig Inc. for alleged patent infringement in connection with the Company's incorporation of heart rate monitors into certain of its cardio products. The Company does not manufacture monitors, but purchases them from third party manufacturers for use on its cardio products. From 2004 through the middle of 2008 no significant activity occurred and the litigation was essentially dormant. The Company does not believe that its use of heart rate monitors purchased from third parties infringe the BioSig patents.

In and around April 2008, following BioSig's hiring of new counsel and the re-assignment of the case to a new federal judge, the litigation activity in the matter has increased. No settlement has occurred or can be predicted to occur at this time.

In addition to the matters described above, from time to time the Company is subject to litigation, claims and assessments that arise in the ordinary course of business, including disputes that may arise from intellectual property related matters. Many of our legal matters are covered in whole or in part by insurance. Management believes that any liability resulting from such matters will not have a material adverse effect on the Company's financial position, results of operations, or cash flows.

### Guarantees and Commitments

At September 30, 2008, the Company had approximately \$4.3 million in outstanding commercial letters of credit with \$0.3 million expiring on December 6, 2008 and \$4.0 million expiring on June 30, 2009.

The Company has long lead times for inventory purchases and therefore needs to secure factory capacity from its vendors in advance. At September 30, 2008, the Company had approximately \$15.2 million in purchase obligations, all of which was for inventory purchases.

## **14. REPORTABLE SEGMENTS AND RELATED INFORMATION**

In the second quarter of 2008, the Company began reorganizing its internal structure to establish teams with authority and responsibility for the operations of the global direct, commercial and retail business units as well as the corporate functions. Each business unit is focusing on improving shareholder return with a particular focus currently on operating effectiveness and costs, market position and product innovation. As a result of the changes in the internal organization, the Company has changed its reportable segments and will report direct, commercial and retail businesses and the corporate functions. Income statement data has been restated for previous periods to correspond with the current segment definitions.

Net sales to external customers for the Company's continuing operations were as follows:

<u>(in thousands)</u>	<u>Three Months Ended</u> <u>September 30,</u>		<u>Nine Months Ended</u> <u>September 30,</u>	
	<u>2008</u>	<u>2007</u>	<u>2008</u>	<u>2007</u>
Direct	\$ 38,672	\$ 58,812	\$ 149,615	\$ 187,145
Retail	26,377	26,375	78,199	73,288
Commercial	28,365	29,744	88,805	92,675
Corporate (*)	335	326	2,295	1,656
Net sales	<u>\$ 93,749</u>	<u>\$ 115,257</u>	<u>\$ 318,914</u>	<u>\$ 354,764</u>

(\*) Revenue in the corporate function is royalty income derived from the Company licensing patents, technologies or trademarks.

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Following is a reconciliation of the Company's segment operating income (loss) to loss before income taxes, from continuing operations:

<u>(in thousands)</u>	<u>Three Months Ended</u> <u>September 30,</u>		<u>Nine Months Ended</u> <u>September 30,</u>	
	<u>2008</u>	<u>2007</u>	<u>2008</u>	<u>2007</u>
Direct	\$ (1,264)	\$ (1,002)	\$ 4,585	\$ 5,872
Retail	4,199	(7,756)	6,627	(10,281)
Commercial	(8,657)	(4,218)	(14,364)	(9,098)
Corporate	(7,654)	(10,270)	(32,951)	(7,423)
Operating loss	(13,376)	(23,246)	(36,103)	(20,930)
Other expense, net	(372)	(1,016)	(1,436)	(2,090)
Loss from continuing operations before income taxes	<u>\$ (13,748)</u>	<u>\$ (24,262)</u>	<u>\$ (37,539)</u>	<u>\$ (23,020)</u>

The Company has not yet completed the accounting processes to capture and report balance sheet data by reportable segment for the current period and the prior comparative periods. The Company's reportable segments in the last annual report on Form 10-K filed in March 2008 were reported on a geographical basis with two reportable segments, the Fitness Equipment Business and the International Equipment Business.

The following table presents assets based on the Company's operating segments as reported at December 31, 2007:

<u>(in thousands)</u>	<u>September 30,</u> <u>2008</u>	<u>December 31,</u> <u>2007(*)</u>
Fitness Equipment Business, including corporate and other centralized functions	\$ 204,427	\$ 346,268
International Equipment Business	38,677	44,572
Total Assets	<u>\$ 243,104</u>	<u>\$ 390,840</u>

(\*) Assets for the Fitness Equipment Business included \$73.8 million of assets for the Pearl Izumi business which was classified as discontinued operations at December 31, 2007. Pearl Izumi was sold on April 18, 2008. See additional information regarding the sale of the Pearl Izumi business in Note 2.

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

**FORWARD-LOOKING STATEMENTS**

This quarterly report on Form 10-Q contains forward-looking statements. Forward-looking statements include any statements related to our expectations regarding future performance or conditions, including any statements regarding anticipated sales growth across markets, distribution channels, and product categories, expenses and gross margins, expense as a percentage of revenue, anticipated earnings, new product introductions, future capital expenditures, anticipated tax benefits, financing and working capital requirements and resources. These forward-looking statements, and others we make from time to time, are subject to a number of risks and uncertainties. Many factors could cause actual results to differ materially from those projected in forward-looking statements, including the risks described in our most recent Annual Report on Form 10-K which are summarized below.

- Availability of media time and fluctuating advertising rates;
- Ability to successfully transfer products to alternative manufacturing facilities;
- Manufacturing quality issues resulting in increased warranty costs;
- Our ability to effectively restructure the business and reduce costs;
- A decline in consumer spending due to unfavorable economic conditions;
- A change in the availability of credit for our customers who finance their purchases;
- Our ability to effectively develop, market and sell future products;
- Our ability to get foreign-sourced product through customs in a timely manner;
- Our ability to effectively identify, negotiate and integrate any future strategic acquisitions;
- Our ability to protect our intellectual property;
- The introduction of lower-priced competing products, unpredictable events and circumstances relating to international operations including the use of foreign manufacturers; and
- Government regulatory action.

We do not undertake any duty to update forward-looking statements after the date they are made or to conform them to actual results or to changes in circumstances or expectations.

This Management's Discussion and Analysis of Financial Condition and Results of Operation (the "MD&A") should be read in conjunction with our consolidated financial statements and related notes located at Item 1 of this Form 10-Q. We believe that period-to-period comparisons of our operating results are not necessarily indicative of future performance. You should consider our prospects in light of the risks, expenses and difficulties frequently encountered by companies that operate in evolving markets. We may not be able to successfully address these risks and difficulties and, consequently, we cannot assure you of any future growth or profitability.

**SUMMARY OF THE THIRD QUARTER 2008 RESULTS**

We are aggressively seeking to improve the Company's operations and financial condition. Our balance sheet and liquidity have been strengthened by the sale of our apparel business, the termination of our proposed acquisition of Land America and the structural improvements we are making in our operations. We have realigned the Company by global commercial, retail and direct businesses and have established separate teams with accountability for each of our business units. Each of the business units is focused on improving shareholder returns with particular focus currently on working capital management to generate liquidity, operating effectiveness, cost reductions and product innovation. We believe that our brands are some of the strongest in the industry and we are focused on capitalizing on that brand recognition. Although our restructuring plan has not been entirely implemented, and in spite of the present difficult economic environment, we are seeing benefits from our efforts.

Net sales for the third quarter of 2008 were \$93.7 million, compared to \$115.3 million in the same quarter of 2007, a decrease of \$21.5 million or 18.7%. Gross profit margins decreased to 31.7% in the third quarter of 2008, compared to 37.6% in the same quarter of 2007, as a result of changes in product and business unit mix as well as cost of goods charges primarily related to the closure of our Tulsa manufacturing facility. The decrease in sales is primarily weakness in our direct business due to the overall consumer environment and credit market disruptions, as well as an internal decision to reduce the level of discounting versus the prior year to improve product margins within the direct business.

Operating expenses for the third quarter of 2008 were \$43.1 million compared to \$66.6 million in the third quarter of 2007. The decrease in operating expenses is primarily the result of progress we are making on our restructuring plan and a \$4.8 million charge to bad debt expense in the prior year as a result of a former customer filing for Chapter 11 bankruptcy. The decrease in operating expenses was partially offset by a \$1.1 million non-cash write off of deferred financing fees in the third quarter 2008 related to the reduction of the borrowing limit in the Company's revolving credit agreement.

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In April 2008, the Company completed the sale of Pearl Izumi, its former fitness apparel business. Assets, liabilities and results of operations associated with the fitness apparel business have been presented in the consolidated financial statements as discontinued operations.

### RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2008 AND 2007

The following tables present certain consolidated financial data as a percentage of net sales and statement of operations data comparing results for the three months ended September 30, 2008 and 2007:

(in thousands)	Three Months Ended September 30,					
	2008	% of net sales	2007	% of net sales	\$ change	% change
Net sales	\$ 93,749	100.0%	\$115,257	100.0%	\$(21,508)	(18.7%)
Cost of sales	64,019	68.3%	71,926	62.4%	(7,907)	(11.0%)
Gross profit	29,730	31.7%	43,331	37.6%	(13,601)	(31.4%)
Operating expenses:						
Selling and marketing	29,852	31.8%	49,872	43.3%	(20,020)	(40.1%)
General and administrative	11,011	11.7%	14,150	12.3%	(3,139)	(22.2%)
Research and development	2,243	2.4%	2,555	2.2%	(312)	(12.2%)
Total operating expenses	43,106	46.0%	66,577	57.8%	(23,471)	(35.3%)
Operating loss	(13,376)	(14.3%)	(23,246)	(20.2%)	9,870	42.5%
Other Income (Expense):						
Interest income	38	0.0%	91	0.1%	(53)	(58.2%)
Interest expense	(169)	(0.2%)	(1,606)	(1.4%)	1,437	89.5%
Other income (expense), net	(241)	(0.3%)	499	0.4%	(740)	(148.3%)
Total other expense	(372)	(0.4%)	(1,016)	(0.9%)	644	63.4%
Loss from continuing operations before income taxes	(13,748)	(14.7%)	(24,262)	(21.1%)	10,514	43.3%
Income tax expense (benefit)	21,512	22.9%	(9,818)	(8.5%)	31,330	(319.1%)
Loss from continuing operations	(35,260)	(37.6%)	(14,444)	(12.5%)	(20,816)	(144.1%)
Income from discontinued operations, net of tax	1,142		997		145	
Net loss	<u>\$(34,118)</u>		<u>\$(13,447)</u>		<u>\$(20,671)</u>	

### Net Sales

The Company is operating in a weak consumer and tight credit environment that we believe is contributing to softer domestic sales of our products. In the third quarter of 2008, we continued our efforts to restructure our organization to create teams accountable for profitability of the direct, retail and commercial global business units. Net sales were \$93.7 million compared to \$115.3 million in the third quarter of 2007 or a decline of 18.7%. The decline in net sales is due to lower sales in the direct business of \$20.1 million and the commercial business of \$1.4 million.

In the **direct business**, net sales declined \$20.1 million to \$38.7 million compared to \$58.8 million in the third quarter of 2007 or a decrease of 34.2%. Sales in the direct channel consist of our Bowflex branded products and primarily include our rod-based home gyms, certain TreadClimber products, SelectTech dumbbells, and the Bowflex Revolution home gym. The decrease in net sales was primarily the result of declines in all product lines as a result of lower advertising dollars in the current period, lower conversion rates for interested customers making a purchase and a reduction in discounting compared to the prior year. In the third quarter of 2007, the Company offered large discounts and free freight to encourage customers to purchase our home fitness equipment. In addition, in the 2008 quarter economic factors such as record high gas prices, rising food prices and the credit crisis had a direct impact on the credit approval rates for our customers who finance their purchases. We have experienced lower credit approval rates for our higher sales price products like the TreadClimber and Revolution and expect to focus on introducing lower priced products in the direct business in the future. In addition, the Revolution product lines received additional consumer financing support through the second quarter of 2008 which allowed more customers to qualify for financing of this product in the form of higher credit lines at higher costs to the Company. Discontinuation of the financing support led to lower sales of the Revolution product lines but should improve overall profitability in future periods.

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In the **retail business**, net sales remained flat at \$26.4 million, compared to the third quarter of 2007. Sales in this business are primarily to various sporting good stores, warehouse clubs, department stores, fitness retail stores and independent bicycle dealers that typically sell health club-quality equipment to the end consumer for home and small business use. Sales in this channel were led by increased distribution of Schwinn branded cardio products as we seek to increase our presence in the much larger cardio segment of the fitness business. About 70% of fitness industry sales globally are cardio products while we have historically had stronger sales in the strength product category. We seek to expand our cardio presence in the future to be more aligned with consumer demand. Although sales in the retail channel were consistent with the prior year quarter, economic conditions deteriorated in the last part of the third quarter are likely to impact our retail customers which may have an impact on our net sales in this channel during the fourth quarter of 2008 and beyond.

In the **commercial business**, net sales declined \$1.4 million to \$28.4 million compared to \$29.7 million in the third quarter of 2007, or a decrease of 4.6%. Sales in this channel are primarily to commercial dealers, health clubs and hotels. Sales declined in the third quarter of 2008 primarily due to the decision to suspend sales of the commercial TreadClimber product due to durability issues. The decline in TreadClimber sales was offset by increased sales of the Nautilus One and F3 strength products, as well as increased sales in our Stairmaster products which received product upgrades in early 2008. International sales represent approximately 42% of the total sales in this channel.

In the **corporate function**, royalty income was \$0.3 million in the third quarter of 2008 compared to \$0.3 million in the same period of 2007. Royalty income represents the revenue the Company receives for licensing certain owned patents and trademarks to other companies.

### **Gross Profit**

As a result of lower net sales and lower gross margins, total gross profit decreased \$13.6 million to \$29.7 million compared to \$43.3 million in the third quarter of 2007, or a decrease of 31.4%. As a percentage of net sales, gross profit margins decreased to 31.7% in the third quarter of 2008 compared to 37.6% in the comparable period of 2007. Direct business sales, which have a substantially higher gross profit margin, declined 34.2% from the prior year quarter leading the decline in gross profit. Additional reasons for the decline in gross profit include \$4.1 million of charges related to closing the Tulsa manufacturing facility and transferring operations, a \$1.8 million charge to inventory reserves related to excess parts and accessories as the Company is working to consolidate warehouse and distribution space. Excluding these charges, our adjusted gross profit margin was 38%. We will continue to face gross margin pressure until the sales mix shifts back towards the direct business.

### **Operating Expenses**

#### Selling and Marketing

Selling and marketing expenses were \$29.9 million in the third quarter of 2008 compared to \$49.9 million in the same period of 2007, a decrease of \$20.0 million or 40.1%. The reduction in marketing expense is primarily a result of a \$5.1 million decline in advertising and media as we seek to obtain a better return on our advertising investment; a \$4.8 million bad debt expense related to the third quarter 2007 bankruptcy filing by a former customer; a \$1.7 million reduction in personnel costs due to reductions in headcount; a \$1.0 million reduction in financing fees due to lower sales in the direct business; a \$0.5 million decrease in catalog costs due to reduced focus on use of catalogs as a selling tool; a \$0.8 million reduction in fees for use of a third party to sell discontinued and refurbished products over the internet; and over \$2.0 million in reductions for various promotions, tradeshow and other discretionary services received in 2007 that have been scaled back or eliminated in 2008. In addition, the Company closed its operations in Australia which reduced selling and marketing expenses by \$0.6 million compared to the prior year.

#### General and Administrative

General and administrative expenses were \$11.0 million in the third quarter of 2008 compared to \$14.1 million in the same period of 2007, a decrease of \$3.1 million or 22.2%. The 2008 total includes a \$1.1 million charge in banking fees as the Company reduced the borrowing capacity under its revolving line of credit agreement offset by a \$1.9 million reduction in personnel costs. The 2007 total includes \$2.3 million of severance costs related to our former chief executive officer.

#### Research and Development

Research and development expenses were \$2.2 million in the third quarter of 2008 compared to \$2.6 million in the same period of 2007, a decrease of \$0.3 million or 12.2%. The decrease in research and development expenses was the result of a \$0.5 million decrease in personnel expenses compared with the third quarter of 2007; a \$0.2 million decrease in prototype expenses related to the Nautilus One product launch in 2007; and general decreases in discretionary expenses such as travel and use of consultants due to the restructuring efforts; offset by a \$0.4 million charge in preproduction royalties related to a new product being developed.

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### ***Other Income (Expense)***

#### ***Interest expense***

Interest expense decreased to \$169,000 in the third quarter of 2008 compared to \$1.6 million in the same period of 2007, as proceeds from the sale of the Company's fitness apparel business were used to reduce borrowings.

#### ***Other Income, net***

Other Income, net decreased to an expense of \$0.2 million in the third quarter of 2008 compared to income of \$0.5 million in the comparable period of 2007. The decrease is due to foreign currency losses realized by the Company in 2008 based on currency fluctuations.

### ***Income Tax Expense (Benefit)***

The provision for income tax from continuing operations was an expense of \$21.5 million in the third quarter of 2008 compared to a benefit of \$9.8 million in the same period of 2007. During the third quarter of 2008, the Company concluded that an overall valuation allowance in the amount of \$26.8 million is required for substantially all deferred tax assets due to the accounting requirements of SFAS 109. The recording of a tax asset valuation allowance will substantially eliminate tax benefit in a period of losses but similarly will substantially eliminate tax expense upon a return to profitability. Accordingly, the Company will record minimal income tax expense or benefit in future periods until the valuation allowance is fully utilized or reversed. We have a twenty year carry forward period for our net operating losses.

### ***Discontinued Operations***

The Company designated the financial results of its fitness apparel business, Pearl Izumi, as discontinued operations during 2007. This resulted in recording the financial results as income from discontinued operations. The income from discontinued operations (net of tax) during the third quarter of 2008 was \$1.1 million compared to \$1.0 million during the prior year quarter.

### ***SUMMARY OF RESULTS FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2008***

Net sales for the first nine months of 2008 were \$318.9 million, compared to \$354.8 million for the same period of 2007, a decrease of 10.1%. Gross profit margins decreased to 37.5% in the first nine months of 2008, compared to 40.6% in the same period of 2007. This decline is a result of changes in product and channel mix primarily driven by lower sales within the direct channel due to a soft North American home market for home exercise strength products and reduced promotions offered in the current year; charges related to the closing the Tulsa, Oklahoma manufacturing facility; transferring certain manufacturing and distribution operations to Independence, Virginia; and right sizing our parts and finished goods inventory as we eliminate products to simplify our business, reduce the number of distribution centers being utilized and reduce overall product handling costs.

Operating expenses for the first nine months of 2008 were \$155.7 million compared to \$165.0 million (which included an \$18.3 million reduction in operating expenses in 2007 for access to intellectual property as settlement of a lawsuit). The decrease in operating expenses is primarily the result of an ongoing review of global operations to restructure the Company to improve profitability. Restructuring activities have resulted in \$4.8 million of severance charges in the first nine months of 2008 as the Company reduced headcount and reorganized along channels of business. In addition, the Company incurred a number of additional charges including an \$8.0 million payment in settlement of all claims arising out of or related to the termination of the agreement with Land America to purchase their China based manufacturing assets; \$1.5 million charge for contracts related to licensing matters in the second quarter 2008 and a \$1.1 million charge for reducing the revolving line of credit during the third quarter 2008.

In April 2008, the Company completed the sale of Pearl Izumi, its former fitness apparel business. Assets, liabilities and results of operations associated with that business have been presented in the consolidated financial statements as discontinued operations.

## RESULTS OF OPERATIONS FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2008 AND 2007

The following tables present certain consolidated financial data as a percentage of net sales and statement of income data comparing results for the nine months ended September 30, 2008 and 2007:

(In Thousands)	Nine Months Ended September 30,					
	2008	% of net sales	2007	% of net sales	\$ change	% change
Net sales	\$318,914	100.0%	\$354,764	100.0%	\$(35,850)	(10.1%)
Cost of sales	199,325	62.5%	210,689	59.4%	(11,364)	(5.4%)
Gross profit	119,589	37.5%	144,075	40.6%	(24,486)	(17.0%)
Operating expenses:						
Selling and marketing	103,566	32.5%	138,288	39.0%	(34,722)	(25.1%)
General and administrative	45,717	14.3%	37,036	10.4%	8,681	23.4%
Research and development	6,409	2.0%	7,981	2.2%	(1,572)	(19.7%)
Litigation settlement	—	0.0%	(18,300)	(5.2%)	18,300	100.0%
Total operating expenses	155,692	48.8%	165,005	46.5%	(9,313)	(5.6%)
Operating loss	(36,103)	(11.3%)	(20,930)	(5.9%)	(15,173)	(72.5%)
Other income (expense):						
Interest income	128	0.0%	244	0.1%	(116)	(47.5%)
Interest expense	(1,499)	(0.5%)	(3,357)	(0.9%)	1,858	55.3%
Other income (expense), net	(65)	0.0%	1,023	0.3%	(1,088)	(106.4%)
Total other expense	(1,436)	(0.5%)	(2,090)	(0.6%)	654	31.3%
Loss from continuing operations before income taxes	(37,539)	(11.8%)	(23,020)	(6.5%)	(14,519)	(63.1%)
Income tax expense (benefit)	14,236	4.5%	(9,221)	(2.6%)	23,457	(254.4%)
Loss from continuing operations	(51,775)	(16.2%)	(13,799)	(3.9%)	(37,976)	(275.2%)
Income from discontinued operations, net of tax	2,421		3,924		(1,503)	
Net income (loss)	<u>\$ (49,354)</u>		<u>\$ (9,875)</u>		<u>\$(39,479)</u>	

### Net Sales

The Company is operating in an uncertain consumer environment that we believe is contributing to softer domestic sales. In 2008, we began an aggressive restructuring effort focused on profitability and cash flows of the direct, retail and commercial global business units. Net sales were \$318.9 million compared to \$354.8 million for the first nine months of 2007 or a decline of 10.1%. The decline in net sales is due to lower sales in the direct business of \$37.5 million and the commercial business of \$3.9 million, offset by an increase in net sales of \$4.9 million in the retail business. The remainder of net sales consists of revenue from royalty agreements.

In the **direct business**, net sales declined \$37.5 million to \$149.6 million compared to \$187.1 million in the first nine months of 2007 or a decrease of 20.1%. The decrease in net sales was primarily the result of declines in the sales of rod-based home gyms and the home version of certain TreadClimber products partially offset by an increase in sales of the Revolution product lines. The decline in rod-based home gym sales are partially explained by a decrease in advertising dollars in 2008 along with a reduction in discounting compared to the prior year. We believe TreadClimber revenue was adversely impacted by less efficient marketing activity due to the need to update our advertisements, a decrease in advertising dollars and a difficult financial market as most customers finance their purchase of this product. In addition, sales of TreadClimber products in the first quarter of 2007 were affected by a lack of product availability in the fourth quarter of 2006 which led to higher shipments in the first quarter of 2007. The introduction of the Revo XP model helped drive growth in Revolution product family revenue in 2008.

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In the **retail business**, net sales increased \$4.9 million to \$78.2 million compared to \$73.3 million in the first nine months of 2007, an increase of 6.7%. Increased sales in this business were led by SelectTech dumbbells and Schwinn ellipticals as we increased our presence in large sporting goods stores during 2008. These increases were offset by a decline in sales of rod-based home gyms as the Company has reduced the number of rod-based products offered in this channel.

In the **commercial business**, net sales declined \$3.9 million to \$88.8 million compared to \$92.7 million in the first nine months of 2007, a decrease of 4.2%. Sales declined in the first nine months of 2008 primarily due to the decision to suspend sales of the commercial TreadClimber products due to durability issues. In addition, the Company's restructuring efforts and focus on channel profitability are expected to improve profitability in future periods as we focus on selling higher margin products. We launched the Nautilus One product line in the third quarter of 2007 which added revenue during 2008 and refreshed the Stairmaster products which have increased demand. International sales represent approximately 45% of the total sales in this channel and the international business benefited in 2007 as a result of currency fluctuations.

In the **corporate function**, royalty income increased to \$2.3 million compared to \$1.7 million in the first nine months of 2007. The increase is a result of having more companies utilizing our patents and trademarks. Royalty income represents the revenue the Company receives for licensing certain owned patents, trademarks and brands to other companies.

### **Gross Profit**

As a percentage of net sales, gross profit margin decreased to 37.5% in the first nine months of 2008 compared to 40.6% in the comparable period of 2007. The decline in gross profit was primarily the result of a change in sales mix and an overall 10.0% decline in sales. Direct business sales, which have a substantially higher gross profit margin, declined 20.0% from the prior period leading the decline in overall gross profit margin. In addition, overall sales declined faster than the Company could reduce fixed costs of manufacturing and distribution. In July 2008 the Company made the decision to close its manufacturing facility in Tulsa, Oklahoma and transfer certain functions to another owned facility in Virginia. This decision has resulted in charges of \$4.1 million. Additional reasons for the decline in gross profit include a decrease in vendor rebates of \$2.4 million due to termination of the Land America acquisition agreement; and increased freight expenses related to higher fuel costs and backorders on a new commercial strength product line which required additional shipping and handling costs to deliver to our customers. In addition, we have identified products that will no longer be sold, resulting in increased inventory reserves for parts and finished goods inventories of approximately \$3.2 million.

### **Operating Expenses**

#### Selling and Marketing

Selling and marketing expenses were \$103.6 million in the first nine months of 2008 compared to \$138.3 million in the same period of 2007, a decrease of \$34.7 million or 25.1%. The reduction in marketing expense is a result of a \$9.8 million decline in advertising and media expenses as the Company adjusted media spend in an attempt to be more efficient and effective with advertising dollars; a \$3.6 million reduction in personnel costs due to reduced headcount; a \$4.8 million bad debt expense related to the third quarter 2007 bankruptcy filing by a former customer; a \$1.6 million decrease in catalog and direct channel mailing costs due to a reduction of use in catalogs as a selling tool; a \$1.7 million reduction in fees for use of a third party to sell discontinued and refurbished products over the internet; a \$1.6 million reduction in financing fees due to lower sales in the direct business; a \$2.2 million reduction in various promotional activities; and a \$1.0 million reduction as a result of termination of certain marketing contracts. In addition, the Company closed its operations in Australia which reduced selling and marketing expenses by \$1.5 million compared to the prior year.

#### General and Administrative

General and administrative expenses were \$45.7 million in the first nine months of 2008 compared to \$37.0 million in the same period of 2007, an increase of \$8.7 million or 23.4%. The increase includes a \$1.7 million increase in severance charges as the Company reorganized by sales channels and an \$8.0 million payment in settlement of all claims arising out of or related to the termination of the purchase agreement with LandAmerica. In addition, the Company incurred \$1.2 million for contracts related to licensing matters and \$0.6 million for reimbursement of costs related to the special meeting of shareholders in December 2007 and \$1.1 million for reducing the borrowing capacity on its revolving line of credit. These expenses were partially offset by reductions in personnel costs of \$3.8 million.

#### Research and Development

Research and development expenses were \$6.4 million in the first nine months of 2008 compared to \$8.0 million in the same period of 2007, a decrease of \$1.6 million or 19.7%. The decrease in research and development expenses was the result of a \$1.0 million decrease in personnel expenses; a \$0.7 million decrease in prototype expenses related to the Nautilus One product; and general decreases in discretionary expenses such as travel and use of consultants due to the restructuring efforts; offset by increased facility charges for using leased space in Colorado and a \$0.4 million charge in preproduction royalties related to a new product in development. During 2008, the research and development team has focused on executing on fewer projects with more effective execution than in 2007 which has helped reduce overall expenses.



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### Litigation Settlement

During the first nine months of 2007, we settled a lawsuit with ICON Health & Fitness, Inc. and as a result we received the rights to utilize a variety of fitness equipment related patents and technologies. We estimated the value of those assets to be \$18.3 million which were recorded as a reduction to 2007 operating expenses.

### **Other Income (Expense)**

#### Interest Expense

Interest expense decreased to \$1.5 million in the first nine months of 2008 compared to \$3.4 million in the same period of 2007 as proceeds from sale of the Company's fitness apparel business were used to reduce borrowings.

#### Other Income (Expense), net

Other Income, net decreased to an expense of \$65,000 in the first nine months of 2008 compared to income of \$1.0 million in the comparable period of 2007. The decrease is due to foreign currency losses realized by the Company in 2008 based on the strengthening dollar in 2008 compared with the decline in the dollar in 2007.

### **Income Tax Expense**

The provision for income tax from continuing operations was an expense of \$14.2 million in the first nine months of 2008 compared to a benefit from continuing operations of \$9.2 million in the same period of 2007. During the third quarter of 2008, the Company concluded that an overall valuation allowance in the amount of \$26.8 million is required for substantially all deferred tax assets due to the accounting requirements of SFAS 109. The recording of a tax asset valuation allowance will substantially eliminate tax benefit in a period of losses but similarly will substantially eliminate tax expense upon a return to profitability. Accordingly, the Company will record minimal income tax expense or benefit in future periods until the valuation allowance is fully utilized or reversed.

### **Discontinued Operations**

The Company designated its fitness apparel business as discontinued operations during 2007. This resulted in recording the financial results as income from discontinued operations. The income from discontinued operations (net of tax) for the nine month period ending September 30 2008 was \$2.4 million compared to \$3.9 million during the prior year period. The decline is a result of closing the operations in April 2008 and was impacted by the tax impact of recording discontinued operations.

## **LIQUIDITY AND CAPITAL RESOURCES**

Our liquidity has been strengthened by the sale of our fitness apparel business, the termination of our proposed acquisition of the China-based manufacturing operations of Land America and the structural improvements we are making in our operations.

During the first nine months of 2008, our operating activities from continuing operations generated \$13.0 million in net cash compared to \$6.1 million in the same period of the prior year. The generation of operating cash in the first nine months of 2008 was primarily from collection of accounts receivable and a reduction of inventory. In addition, the Company received tax refunds of \$8.7 million in the first nine months of 2008. The Company paid \$8.0 million in the second quarter of 2008 in connection with the settlement of all claims related to the termination of the Land America agreements.

Cash provided by investing activities from continuing operations was \$4.1 million in the first nine months of 2008 compared to cash used in investing activities of \$43.9 million in the same period of 2007. The change is primarily due to the return of a \$5 million deposit in escrow related to the abandoned Land America transaction and the collection of a note receivable from a previous business partnership with a nutrition company. In addition, the Company invested \$4.4 million in capital improvements during 2008 which is an intentional reduction from historical capital spend levels. We received \$58.4 million from the sale of Pearl Izumi which is included in investing activities from discontinued operations.

Net cash used in financing activities from continuing operations was \$73.3 million in the first nine months of 2008 compared to \$52.9 million of net cash provided in the same period of the prior year. The increase in cash used in financing activities was primarily due to increased repayments of short-term borrowings as a result of the Company's sale of its fitness apparel business. In the fourth quarter

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of 2007, the Board of Directors suspended the quarterly dividend. Payment of any future dividends is at the discretion of our Board of Directors, which considers various factors such as our financial condition, operating results, current and anticipated cash needs and future expansion plans. The Company's loan agreement contains covenants that include limitations on paying dividends when certain ratios are not met. Based on the covenants, the Company is currently precluded from paying dividends. On May 5, 2008, the Board of Directors authorized the expenditure of up to \$10.0 million to repurchase outstanding shares of the Company's common stock. During the nine months ended September 30, 2008 the Company used \$5.3 million to repurchase stock.

The Company has a Loan and Security Agreement (the "Loan Agreement") with Bank of America N.A., as agent for the lenders party thereto, providing for a \$40 million revolving secured credit line. Current economic and financial conditions make it difficult for companies to obtain financing. In the event of default or loan covenant violation, the current economic and financial conditions would make it difficult to obtain an alternative source of financing. The Company relies on its current banking relationship to meet cash needs due to the Company's cyclical cash flow needs. Subject to the foregoing, we believe our existing cash and cash equivalents, cash generated from operations and borrowings available under our credit facilities will be sufficient to meet our operating and capital requirements in the foreseeable future.

### **OFF-BALANCE SHEET ARRANGEMENTS**

As described in the Company's 2007 Annual Report on Form 10-K, from time to time, we arrange for leases or other financing sources with third parties to enable certain of our commercial customers to purchase our products. While most of these financings are without recourse, in certain cases we may offer a guarantee or other recourse provisions. At September 30, 2008 and December 31, 2007, the maximum contingent liability under all recourse provisions was approximately \$1.0 million and \$1.3 million, respectively.

The Company no longer provides guarantees on consumer financing contracts and has no contingent liability for consumer finance contracts.

### **INFLATION AND PRICE CHANGES**

We have experienced cost increases for products and components manufactured in China reflecting unfavorable foreign currency exchange rates and increases in Chinese wages, taxes and raw material costs which our third party sourcing partners seek to pass along to the Company. Raw material costs have also increased for products manufactured by Company owned facilities in the United States. Gross margins have been and may continue to be negatively impacted if these conditions persist and the Company is unable to find other cost savings or increase selling prices sufficiently to offset the cost increases.

Transportation costs have fluctuated due to changing fuel prices. To the extent these costs continue to increase and we are unable to pass these costs to the customer, our gross margins will continue to be negatively impacted.

### **SEASONALITY**

In general, based on historical trends, we expect our sales from fitness equipment products both in the U.S. and internationally to vary seasonally with sales typically the strongest in the fourth quarter, followed by the first and third quarters, and the weakest in the second quarter. We believe that such factors as the broadcast of national network season finales and seasonal weather patterns influence television viewership and cause our television commercials on national cable television to be less effective in the second quarter than in other periods of the year. In addition, during the spring and summer consumers tend to do more activities outside, including exercise, which impacts sales of fitness equipment used indoors. We expect the fluctuation in our net sales between our highest and lowest quarters to be approximately 35%.

### **CRITICAL ACCOUNTING ESTIMATES AND ASSUMPTIONS**

The preparation of financial statements in conformity with U.S. GAAP requires estimates and assumptions that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities in the consolidated financial statements. As described by the Securities and Exchange Commission ("SEC"), critical accounting estimates and assumptions are those that may be material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change, and that have a material impact on the financial condition or operating performance of the company. Based on this definition, we believe the items listed below are our critical accounting estimates and assumptions:

- Revenue recognition
- Allowance for doubtful accounts
- Inventory valuation
- Product warranty

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- Stock compensation
- Litigation and loss contingencies
- Goodwill and other intangible assets valuation
- Income tax provision

Management regularly discusses with our audit committee each of our critical accounting estimates and assumptions, as well as critical accounting policies presented in the Company's 2007 Annual Report on Form 10-K, and the development and selection of these accounting estimates and the disclosure about each estimate in the MD&A. These discussions typically occur at our quarterly audit committee meetings and include the basis and methodology used in developing and selecting these estimates, the trends in and amounts of these estimates, specific matters affecting the amount of and changes in these estimates, and any other relevant matters related to these estimates, including significant issues concerning accounting principles and financial statement presentation.

The Company will complete a full analysis of impairment for goodwill and other intangible assets during the fourth quarter of 2008. Current market conditions, including a declining market capitalization, declining sales and accumulating operating losses may be indicators that goodwill and other intangible assets are impaired. Although our current analysis did not result in impairment charges during the third quarter of 2008, further changes in economic and market conditions may have an impact on the analysis which may result in the Company recording impairment charges in the future.

## **NEW ACCOUNTING PRONOUNCEMENTS**

For a description of the new accounting standards that affect us, refer to Note 1 to our Consolidated Financial Statements included under Part I, Item 1 of this Form 10-Q.

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

There have been no material changes in our reported market risks since the filing of our 2007 Annual Report on Form 10-K, which was filed with the Securities and Exchange Commission on March 17, 2008.

We hold our cash and cash equivalents primarily in bank deposits and in liquid debt instruments with maturity dates of less than three months. We are subject to concentration of credit risk as bank deposits may exceed federally insured limits

## **FOREIGN EXCHANGE RISK**

We are exposed to foreign exchange risk from currency fluctuations, mainly in Canada, China and Europe, due to sourcing of our products in U.S. dollars and selling them primarily in Canadian dollars, RMB, British pounds, Swiss Francs and Euros. Given the relative size of our current foreign operations, the exposure to the exchange risk could have a material impact on the results of operations. Management estimates the maximum impact on stockholders' equity of a ten percent change in all applicable foreign currency to be approximately \$1.5 million.

## **INTEREST RATE RISK**

Fluctuations in the general level of interest rates on our current variable rate credit agreements expose us to market risk. As of September 30, 2008, our outstanding borrowings under the credit facilities were \$10.5 million. To the extent that the Company needs to rely on indebtedness to finance its operations, a material change in interest rates could have a material impact on the Company's financial position, results of operations, or cash flows.

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

#### ***Evaluation of Disclosure Controls and Procedures***

Our management has evaluated, under the supervision and with the participation of our Chairman and Chief Executive Officer, and Chief Financial Officer the effectiveness of the design and operation of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the "Exchange Act"), as amended) as of the end of the period covered by this quarterly report on Form 10-Q. Based upon that evaluation and the material weakness described below, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the period covered by this quarterly report on Form 10-Q, the Company's disclosure controls and procedures were ineffective.

As previously disclosed under "Item 9A. Controls and Procedures" in our Annual Report on Form 10-K for our 2007 fiscal year, our management identified a material weakness in our internal control over financial reporting as of December 31, 2007 as described below. Management concluded that the controls around the review of significant non-routine transactions and the review of significant management estimates and reserves did not operate effectively, resulting in audit adjustments to the 2007 consolidated financial statements. These deficiencies, if left unremediated, could result in the failure to prevent or detect a material misstatement in the Company's consolidated financial statements.

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Notwithstanding management's evaluation that our internal control over financial reporting was not effective as of December 31, 2007, we believe that the consolidated financial statements included in this Quarterly Report on Form 10-Q fairly present our financial condition, results of operations and cash flows for the periods covered thereby in all material respects.

Our management does not expect that our disclosure controls and procedures will prevent or detect all errors and fraud. Any control system, no matter how well designed and operated, is based on certain assumptions and can provide only reasonable, not absolute assurance, that its objectives will be met. Further, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, within the Company have been detected.

### ***Changes in Internal Controls***

#### ***Remediation Efforts on the Internal Controls Surrounding Management's Review of Significant Non-Routine Transactions and Review of Significant Estimates and Reserves.***

The following remedial actions have or will be undertaken to address the material weakness in the controls around the review of significant non-routine transactions and the review of significant management estimates and reserves:

- The accounting and finance organization is being restructured to allow key personnel to focus on corporate accounting and external reporting.
- Additional training has been or will be provided to accounting personnel for specific technical areas of high risk.
- Key accounting personnel have been assigned to perform monthly review of all significant non-routine transactions and significant management estimates and reserves.
- The external reporting timeline is being adjusted to allow adequate time for management review and analysis, including significant non-routine transactions and significant management estimates and reserves.

Management has made significant progress in remediating the material weakness identified at December 31, 2007 and is continuing to closely monitor the effectiveness of our processes, procedures and controls, and will make any further changes as management determines appropriate.

Except in connection with actions we are taking to remediate the material weakness in our internal control over financial reporting discussed above, there was no change in our internal control over financial reporting that occurred during the fiscal quarter covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. The material weakness in our internal control over financial reporting that existed as of December 31, 2007, as described above and as disclosed in Item 9A of our Annual Report on Form 10-K, has not yet been fully remediated as of September 30, 2008.

## **PART II. OTHER INFORMATION**

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

For a description of the legal proceedings that affect us, refer to Note 12 to the consolidated financial statements located at Item 1 of this Form 10-Q.

### **Item 1A.    Risk Factors**

There have been no material changes to the risk factors identified in our annual report on Form 10-K for the year-ended December 31, 2007, except that the following risk factor is added to supplement the risk factors identified in our annual report:

#### ***Our business may be disrupted by the closure of our Tulsa manufacturing facility.***

If we are unable to transition the manufacture of certain products from our Tulsa manufacturing facility, which we are closing, to other manufacturing facilities without significant disruption, certain products might not be available for us to sell and gross profits and overall income from operations may be adversely affected.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

Registrant's Purchases of Equity Securities:

<u>Period</u>	<u>Total Number of Shares Purchased</u>	<u>Average Price Paid per Share</u>	<u>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1)</u>	<u>Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs</u>
July 1, 2008 to July 31, 2008	618,068	\$ 5.03	618,068	\$ 4,679,670
August 1, 2008 to August 31, 2008	—	—	—	4,679,670
September 1, 2008 to September 30, 2008	—	—	—	4,679,670
Total	<u>618,068</u>	<u>\$ 5.03</u>	<u>618,068</u>	<u>\$ 4,679,670</u>

- (1) On May 4, 2008, the Company's Board of Directors announced the authorized repurchase of up to \$10 million of the Company's common stock in open-market transactions, at times and in such amounts as management deems appropriate, depending on market conditions and other factors. The authorization continues until such date as the Board of Directors shall terminate such authorization; provided, the aggregate amount spent on such repurchases does not exceed \$10 million. The repurchase program does not obligate the Company to acquire any specific number of shares or acquire shares over any specified period of time. In second quarter of 2008, the Company repurchased 414,732 shares for \$2.2 million.

As further discussed in Note 8, the Company entered into a Third Amendment to the Loan Agreement ("Third Amendment") on May 5, 2008. Pursuant to the Third Amendment, the lenders consented to the repurchase by the Company of up to \$10.0 million of its common stock.

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### **Item 6.**      **Exhibits**

The following exhibits are filed herewith.

<b><u>Exhibit No.</u></b>	<b><u>Description</u></b>
10.1	Fourth Amended and Restated Merchant Agreement dated as of October 27, 2008 by and between Nautilus, Inc. and HSBC Bank Nevada, N.A. (Confidential treatment has been requested with respect to a portion of this agreement.)
31.1	Certification of Principal Executive Officer pursuant to Rule 13a-14 (a) of the Securities Exchange Act of 1934, as amended
31.2	Certification of Principal Financial Officer pursuant to Rule 13a-14 (a) of the Securities Exchange Act of 1934, as amended
32.1	Certification of Principal Executive Officer and Principal Financial Officer pursuant to Rule 13a-14(b) of the Securities and Exchange Act of 1934, as amended, and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURES

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

NAUTILUS, INC.

November 10, 2008  
Date

By: /s/ Edward J. Bramson  
Edward J. Bramson,  
Chairman and Chief Executive Officer  
(Principal Executive Officer)

November 10, 2008  
Date

By: /s/ William D. Meadowcroft  
William D. Meadowcroft,  
Chief Financial Officer  
(Principal Financial Officer)

**EXHIBIT INDEX**

<b>Exhibit No.</b>	<b>Description</b>
10.1	Fourth Amended and Restated Merchant Agreement dated as of October 27, 2008 by and between Nautilus, Inc. and HSBC Bank Nevada, N.A. (Confidential treatment has been requested with respect to a portion of this exhibit.)
31.1	Certification of Principal Executive Officer pursuant to Rule 13a-14 (a) of the Securities Exchange Act of 1934, as amended
31.2	Certification of Principal Financial Officer pursuant to Rule 13a-14 (a) of the Securities Exchange Act of 1934, as amended
32.1	Certification of Principal Executive Officer and Principal Financial Officer pursuant to Rule 13a-14(b) of the Securities and Exchange Act of 1934, as amended, and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002



**FOURTH AMENDED AND RESTATED**

**MERCHANT AGREEMENT**

**BETWEEN**

**NAUTILUS, INC.**

**AND**

**HSBC BANK NEVADA, NATIONAL ASSOCIATION**

**Dated as of October 27, 2008**

**Effective as of January 1, 2009**

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FOURTH AMENDED AND RESTATED  
MERCHANT AGREEMENT

This Fourth Amended and Restated Merchant Agreement (“Agreement”) is made and entered into as of the 27th day of October, 2008, and is effective as of January 1, 2009 (“Effective Date”), by and between HSBC BANK NEVADA, NATIONAL ASSOCIATION (herein “HSBC”), with its principal place of business at 1111 Town Center Drive, Las Vegas, NV 89144 and NAUTILUS, INC., a Washington corporation (herein “Merchant”), with its principal place of business at 16400 SE Nautilus Drive, Vancouver, WA 98683.

Whereas, the parties executed that certain Merchant Agreement dated February 4, 1997, as amended by that First Amended and Restated Merchant Agreement dated as of January 27, 1999 and as further amended by that Second Amended and Restated Merchant Agreement dated as of February 23, 2000 and as further amended by that Third Amended and Restated Merchant Agreement dated as of January 17, 2005 (collectively referred to as the “Existing Program Agreement”), and

Whereas, the parties desire to further amend and restate the Existing Program Agreement to reflect certain changes, all as more fully set forth herein.

Now, therefore, in consideration of the mutual promises, covenants, and agreements set forth below and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, Merchant and HSBC agree as follows:

**ARTICLE 1 - DEFINITIONS**

**Section 1.1 Definitions.**

In addition to the words and phrases defined above, the following words and phrases shall have the following meanings:

- (a) “Account” means a private label revolving credit card account established by HSBC for the Cardholder to be used by the Cardholder to finance the purchase of Goods from Merchant pursuant to the terms of the Cardholder Agreement.
- (b) “Adjustment Date” means the first business day of each calendar quarter, beginning January 1, 2009.
- (c) “Affiliate” means any entity that is owned by, owns, or is under common control with, a party or its ultimate parent.
- (d) “Applicable Law” means collectively or individually any applicable law, rule, regulation or judicial, governmental or administrative order, decree, ruling, opinion or interpretation.
- (e) “APR” means annual percentage rate.
- (f) “Authorization” means permission from HSBC to make a Card Sale.
- (g) “Authorization Center” means the facility designated by HSBC as the facility to provide authorization to Merchant to make Card Sales.
- (h) “Base LIBOR” means 2.89%.

- (i) “Base Liquidity Spread” means \*%.
- (j) “Business Day” means any day except Saturday or Sunday or a day on which banks are closed in the State of Nevada.
- (k) “Card” means the private label credit card issued by HSBC for the Program.
- (l) “Cardholder” means (i) the person in whose name an Account is opened, and (ii) any other authorized users of the Account and Card.
- (m) “Cardholder Agreement” means as to any Account, the related agreement between the Cardholder and HSBC, governing the terms and conditions of such Account, as such agreement may be amended from time to time by HSBC.
- (n) “Card Sale” means any sale of Goods that Merchant makes to a Cardholder pursuant to this Agreement and the Cardholder Agreement that is charged to an Account.
- (o) “Chargeback” means the return to Merchant and reimbursement to HSBC of a Sales Slip or Card Sale for which Merchant was previously paid.
- (p) “Commencement Date” means the first date that HSBC funds a Card Sale.
- (q) “Confidential Information” means consumer reports and information derived from consumer reports, and a compilation of such records, but not including any such records that do not personally identify an individual, and all information, software, systems and data that Merchant receives from HSBC or from any other source relating to the Program and matters which are subject to the terms of this Agreement, including, but not limited to, Cardholder names and addresses or other Account information, in any form.
- (r) “Credit Slip” means evidence of a credit in a paper or electronic form for Goods purchased from Merchant.
- (s) “Current LIBOR” means LIBOR determined as of the Adjustment Date, which shall be determined by the LIBOR for the month prior to the Adjustment Date.
- (t) “Current Liquidity Spread” means the Liquidity Spread as of the Adjustment Date.
- (u) “Effective Date” means January 1, 2009.
- (v) “Goods” means fitness equipment and other related products and services sold by Merchant in the ordinary course of Merchant’s business to individual consumers for personal, family or household purposes, and certain warranties expressly authorized by HSBC.
- (w) “LIBOR” means the Business Daily average, for the applicable calendar month, of the one year London Interbank Offered Rate as published by Bloomberg Financial Markets.
- (x) “LIBOR Adjustment” means the result of the appropriate Multiplier for the appropriate plan or promotion, multiplied by the LIBOR Spread.
- (y) “LIBOR Spread” means the difference between Current LIBOR and Base LIBOR.
- (z) “Liquidity Spread” means the spread determined internally by HSBC in its discretion for purposes of general application to merchant programs similarly situated to Merchant.
- (aa) “Liquidity Spread Adjustment” means the result of the appropriate Multiplier for the appropriate plan or promotion, multiplied by the difference between the Current Liquidity Spread and the Base Liquidity Spread.
- (bb) “Month” means a calendar month unless used in connection with a Promotional Credit Plan period.
- (cc) “Multiplier” means the multiplier set forth in Schedule 2.2 for each plan or promotion.
- (dd) “Net Card Sales” means gross Card Sales, minus Normal Business Returns and Chargebacks, during the specified period of time.
- (ee) “Net Monthly Card Sales” means gross Card Sales, minus Normal Business Returns and Chargebacks, for a given Month.
- (ff) “Normal Business Return” means a full refund (i.e., price plus original tax, and shipping and handling if applicable) given in the ordinary course of business by Merchant for (i) a returned product, (ii) a damaged or defective product (iii) a package that is returned marked “undeliverable”, or (iv) a cancellation of services.

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\* Certain information on this page has been omitted and filed separately with the Securities and Exchange Commission. Confidential treatment has been requested with respect to the omitted PORTIONS.

(gg) “Operating Instructions” means the manual provided to Merchant explaining the operation of the Program and periodic instructions sent to Merchant explaining modifications or updates to Program operations.

(hh) “Prime Rate” means the highest Prime Rate published in The Wall Street Journal “Money Rates” section.

(ii) “Program” means the private label revolving credit card program associated with Merchant whereby Accounts will be established and maintained by HSBC, Cards issued by HSBC to qualified consumers purchasing Merchant’s Goods, and Card Sales funded all pursuant to the terms of this Agreement.

(jj) “Program Year” means any consecutive twelve (12) Month period commencing on the first day of funding of Accounts after the Effective Date and each subsequent twelve (12) Month period.

(kk) “Promotional Credit Plan” means one of the promotional credit plans set forth in the Cardholder Agreement.

(ll) “Proprietary Designations” means name, logo, trademarks, servicemarks and any other proprietary designations.

(mm) “Sales Slip” means evidence of a Card Sale in paper or electronic form for Goods purchased from Merchant.

(nn) “Terminal” means an electronic terminal or computer capable of communicating by means of an on-line or dial-up electronic link with an Authorization Center.

(oo) “United States” shall mean the 50 United States and the District of Columbia, but excluding all other territories and possessions of the United States.

## **ARTICLE 2 – ESTABLISHMENT OF PROGRAM AND PROGRAM ECONOMICS**

### **Section 2.1 General Parameters.**

Merchant and HSBC had agreed that HSBC would make financing available to customers of Merchant purchasing Goods from Merchant under the Existing Merchant Agreement. Merchant and HSBC agree that HSBC shall continue to make financing available to individual qualified consumers in the United States purchasing Goods from Merchant, and the parties shall participate in the Program in accordance with the terms and conditions set forth in this Agreement. The parties agree that this Agreement shall supercede and replace the Existing Merchant Agreement.

### **Section 2.2 Credit Programs and Discounts.**

HSBC shall offer a standard credit program and an extended credit program; provided, however, that either party may terminate the extended credit program upon ninety (90) days prior written notice to the other party. Each Sales Slip or Card Sale generated pursuant to a standard revolving plan or Promotional Credit Plan under the standard credit program or extended credit program shall be subject to a discount fee as set forth on Schedule 2.2. Schedule 2.2 may also be modified from time to time by mutual agreement of the parties. If there is a significant change in the regulatory environment, the parties agree to negotiate in good faith any proposed changes to Schedule 2.2.

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### **Section 2.3 Credit Review; Ownership of Accounts.**

All completed applications for Accounts submitted by Merchant to HSBC, whether mailed, telephoned or electronically transmitted, will be processed and approved or declined in accordance with such credit criteria and procedures established from time to time by HSBC, with HSBC having and retaining all rights to reject or accept such applications. HSBC will only accept applications for revolving credit pursuant to the credit card it issues for individual, personal, family or household use. HSBC or its Affiliates shall own the Accounts, as well as the information associated with the Accounts, including names, mailing addresses, and e-mail addresses, and shall bear the credit risk for such Accounts. HSBC shall share such information with Merchant to the extent allowed by Applicable Law. HSBC shall not be obligated to take any action under an Account, including making future advances or credit available to Cardholders. HSBC shall not be obligated to accept applications for a Card or to approve any Card Sale for consumers who do not have their principal residence and billing address in the fifty United States or the District of Columbia, Puerto Rico, the Virgin Islands, Guam or Samoa.

### **Section 2.4 Exclusive Relationship.**

During the term of this Agreement, Merchant shall not issue, arrange to issue, or accept, in the United States, any private label credit card or account other than the Card, under any of Merchant's names or logos, except with respect to Applications declined by HSBC.

### **Section 2.5 Sales, Gross Receipts and Privilege Tax Refunds, Deductions and Credits.**

HSBC and Merchant agree to pursue sales, gross receipts and privilege tax refunds, deductions, and credits pursuant to the attached Schedule 2.5, which is incorporated herein by reference.

## **ARTICLE 3 - MARKETING**

### **Section 3.1 Promotion of Program.**

Merchant shall actively promote the Program. To the extent Merchant displays materials for credit or charge cards issued by other parties, it shall display the advertising and promotional materials relating to the Card in a manner and with a frequency equal to or greater than that accorded any other third party credit or charge card. Merchant shall prominently display at each of its locations, if appropriate, advertising and promotional materials relating to the Card, including, without limitation, take-one applications for the Card and use or display such materials in accordance with any specifications mutually agreed to by HSBC and Merchant. Such materials shall be used only for the purpose of soliciting accounts for the Program. Any solicitation, written material, advertising or the like relating to the credit terms and credit products offered pursuant to the Program shall receive HSBC's prior review and written approval. If HSBC prepares any such material at Merchant's request, HSBC will charge Merchant and Merchant agrees to pay for any such material. Such review and approval by HSBC shall be limited to the review and approval of the credit terms and credit products and shall not be construed as review or approval of any advertising or solicitation materials for any other purpose or for compliance with any provisions of any local, state or federal advertising laws not related to credit terms or credit products. Following termination of this Agreement, Merchant shall not use any such materials.

### **Section 3.2 Card Promotions, Services and Enhancements.**

HSBC and Merchant may from time to time mutually agree to offer to existing or potential Cardholders additional credit promotions, additional services and/or enhancements. The terms of such promotions, services and enhancements shall be mutually agreed upon by HSBC and Merchant and are subject to change or discontinuance by HSBC.



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## **ARTICLE 4 – CUSTOMER TERMS**

### **Section 4.1 Annual Percentage Rate**

The APR to be charged on purchases with the Card shall be 21.8% for the Standard APR, or 25.8% for the Default APR. The APR shall not exceed the maximum interest rate allowable by Applicable Law.

### **Section 4.2 Late Fees**

A late fee of \$39.00 may be charged for payments not received by the payment due date listed in the Cardholder Agreement.

### **Section 4.3 Minimum Payment**

The minimum monthly payment shall be 1.5% of the principal balance plus current billed finance charges plus any current billed fees, or \$10, whichever is greater.

### **Section 4.4 Change of Terms**

HSBC may change the terms in this Article 4 upon 30 days prior written notice to Merchant.

## **ARTICLE 5 - OPERATIONAL RESPONSIBILITIES**

### **Section 5.1 Consumer Transactions.**

Merchant shall honor all valid Cards without discrimination, when properly presented by Cardholders for payment of Goods.

### **Section 5.2 Surcharges and Differential Treatment.**

Merchant shall not require, through an increase in price or otherwise (other than price increases in Merchant's Goods of general application applied equally to Cardholders and non- Cardholders), any Cardholder to pay any surcharge at the time of sale or pay any part of any charge imposed by HSBC on Merchant. Merchant shall not provide any discounts to customers for using cash or any other tender or credit device that is also not provided to customers using the Card.

### **Section 5.3 Forms and Cards.**

HSBC shall provide, and Merchant shall only use, the applications, Sales Slips, Credits Slips, and Cardholder Agreements (collectively, the "Cardholder Documents") as are provided by HSBC , and not use any Cardholder Documents provided by HSBC other than in connection with an application for a Card or a Card transaction. When provided by HSBC with a new edition of forms with the instruction to replace the previous editions with the new editions by a certain date, Merchant shall do so in accordance with the instructions. HSBC and Merchant shall agree upon the design of Cards and applications. HSBC shall be responsible for card production and issuance and will pay for the issuance of Cards to Cardholders. The terms and conditions set forth on the applications, Cardholder Agreements, and other forms shall be determined by HSBC and are subject to change by HSBC from time to time.

#### Section 5.4 Applications.

Merchant shall, with respect to paper applications that it accepts in its stores:

- (a) make sure all information requested on the application is complete and legible;
- (b) obtain the signature on the application of all persons whose name will appear on the Account or will be responsible for the Account;
- (c) give the applicant the initial disclosures at the time of signing the application/agreement prior to the first transaction under the Account;
- (d) obtain and provide verification of the applicant's identity and current address by (i) witnessing the signature on the application of each person whose name will appear on the Account or who will be responsible for the Account; and (ii) reviewing one of the following: a current drivers license containing the applicant's photo, a current government issued identification card containing the applicant's photo, a valid US Government issued military identification containing the applicant's photo, a valid United States Passport containing the applicant's photo, or a valid United States Alien Registration Card (Green Card) containing the applicant's photo and confirming that the photo on such identification reasonably matches the applicant; and (iii) reviewing an unexpired major credit card (e.g. American Express, VISA, MasterCard, Discover or major private label credit card) and confirming that the signature on such credit card reasonably matches the signature on the application; and (iv) recording on the application where designated the drivers license number or the card type, place of issuance, and, if any, date of issuance and expiration date of such identification, as well as the address if the address differs from the address on the application;
- (e) provide all information required by HSBC for approval of applications and legibly insert the Account number and approval number on the application in the designated area; and
- (f) send the actual original approved signed application to HSBC at HSBC's address on page one above or such other address designated by HSBC within five (5) Business Days of approval of the application by HSBC.
- (g) With respect to Telephone Applications, Merchant shall:
  - (i) Request all information required by HSBC for such applications;
  - (ii) Make sure all information requested on the Telephone Application is complete;
  - (iii) Give the applicant the applicable initial disclosures at the time the Telephone Application information is requested or such other disclosures as may be required by HSBC from time to time;
  - (iv) Provide all information required by HSBC from time to time for approval of Applications by telephone or other electronic transmission;
  - (v) Designate on the Application and/or enter into the Terminal that it was a Telephone Application and Card Sale;
  - (vi) Not submit to HSBC for funding any Sales Slip resulting from a telephone or mail order Card Sale until not less than five (5) Business Days after receipt by Merchant and approval by HSBC of the Telephone or Mail Order Application; and
  - (vii) Merchant represents and warrants that in connection with telephone solicitations, it has adopted such policies and procedures to ensure compliance with all applicable federal and state laws, regulations or rules relating to telemarketing and/or telephone solicitations including but not limited to the Telephone Consumer Protection Act of 1991 ("TCPA") 42 USC 227 and 152(b); Chapter I, Title 47 of the Code of Federal Regulations, parts 64 and 68, the Telemarketing and Consumer Fraud and Abuse Prevention Act (TCFAPA) 15 U.S.C. 6101-6108; 16 CFR Part 310 and any applicable telemarketing or telephone solicitation laws of the state from which and to which Merchant shall be initiating telephone solicitations for the Card.

- (h) With respect to Internet Applications, Merchant shall:
- (i) For all products, include an Application and Cardholder Agreement on its website notifying visitors that they may complete an Application for a Card via the Merchant's Internet website. All Cardholder Agreements and other forms or any terms, conditions or disclosures related thereto required by Applicable Law (as indicated in writing by HSBC to Merchant), including, but not limited to, disclosures required in connection with the Applications, displayed on Merchant's Internet website, shall be displayed or used as provided to Merchant by HSBC, including but not limited to the format, layout, font size, and content thereof and shall be subject to review and approval of HSBC. In the event HSBC has modified rate, fees, discounts and/or charges, HSBC may instruct the Merchant as provided in Section 5.h. (ii) to change, modify or revise the forms and disclosures to be used in connection with the Program;
  - (ii) Change, modify, or revise any forms or disclosures used in connection with the Program in accordance with HSBC's instructions to replace, change, modify or revise the existing forms or disclosures with revised forms and disclosures within two (2) weeks from the date HSBC provides Merchant with notice of such change, modification or revision, or by any such date required by Applicable Law ("Implementation Date"). Where changes are required by Applicable Law, HSBC will use its best efforts to provide notice to Merchant of any such changes within a reasonable time period;
  - (iii) Provide HSBC throughout the term of this Agreement with reasonable access to all forms and disclosures on its website relating to the Program during normal business hours, in accordance with its normal security procedures and without disruption of its normal business operations, in order to allow HSBC and/or any regulatory agencies to which HSBC is subject to review such forms, disclosures and operations for compliance with this Agreement and Applicable Law;
  - (iv) Upon termination of this Agreement, remove from Merchant's website any and all disclosures and forms provided by HSBC and all references to HSBC upon the effective date of said termination.
  - (v) In the event Merchant fails or refuses to adhere to any reasonable instructions from HSBC to replace, change, modify or revise any forms or disclosures by the Implementation Date and such failure creates a significant risk of liability to HSBC under Applicable Law as determined by HSBC, HSBC may, in its sole discretion, (i) assess a one thousand dollar (\$1,000) fine per day for each day of the next five (5) Business Days after the Implementation Date that Merchant fails to adhere to such instructions; (ii) cease the processing of Internet Applications for Accounts and/or cease Authorizations for funding or acceptance of Sales Slips or Card Sales via the Internet on the sixth (6<sup>th</sup>) day after the Implementation Date; and (iii) in addition to any other remedies HSBC may have at law or equity, HSBC will be entitled to seek a restraining order, injunction or other similar remedy and to enforce specifically the terms and provisions contained in this section. Each party hereby acknowledges that money damages alone would be an inadequate remedy for the injuries and damages which would be suffered and incurred as a result of any material breach of the provisions of this section.
  - (vi) Not process any Card Sales under an Account, or if a Card Sale has already been initiated, stop shipment of any Goods, and initiate a credit to the Account if HSBC notifies Merchant that it suspects the Internet Application or Card Sale is fraudulent within forty-eight (48) hours after approval of the Internet Application. If HSBC so notifies Merchant more than forty-eight (48) hours after such approval, Merchant shall use its best efforts to stop shipment of any Goods.

- (vii) Not submit to HSBC for funding any Sales Slip resulting from an Internet Application until not less than five (5) Business Days after receipt by Merchant and approval by HSBC of the Internet Application;
- (viii) Include a copy of the Cardholder Agreement and Disclosure Statement with all Goods shipped via overnight courier;
- (ix) Not permit any additional purchases, Internet or otherwise, on an Account for a period of not less than seven (7) days after notification from HSBC that HSBC has approved an Internet Application for an Account; and,
- (x) Bear the risk for fraud associated with Internet Applications, Accounts originated via such applications, and for goods shipped to an address that does not match HSBC's billing account and reimburse HSBC for related losses including standard APR, but excluding penalties and late fees.

### Section 5.5 Sales Slips.

Merchant shall, with respect to Sales Slips:

- (a) enter legibly or capture electronically on a single Sales Slip (prior to obtaining the Cardholder's signature for in store sales) (i) a description of all Goods purchased in the same transaction in detail sufficient to identify the transaction; (ii) the date of the transaction; (iii) the Authorization number; (iv) the entire amount due for the transaction (including any applicable taxes); (v) if applicable, the Promotional Credit Plan and promotional period; (vi) Cardholder's name and shipping address; (vii) Account number (except that Merchant shall not print more than the last 5 digits of the Account number on any Sales Slip provided to the Cardholder at the point of sale or transaction if the Sales Slip is electronically printed, provided that the full account number may be so printed if the sole means of recording the Account number is by handwriting or by an imprint or copy of the Card); and (viii) Merchant's name and address. If the promotional credit plan and promotional period cannot be entered on the Sales Slip, Merchant shall provide the Cardholder with the Sales Slip, as well as a handout or flyer explaining the promotional credit plan and the promotional period;
- (b) **REQUEST AUTHORIZATION FROM HSBC'S AUTHORIZATION CENTER UNDER ALL CIRCUMSTANCES.** HSBC may refuse to accept or fund any Sales Slip that is presented to HSBC for payment more than sixty days after the date of Authorization of the Card Sale. If Authorization is granted, legibly enter the Authorization number in the designated area on the Sales Slip. If Authorization is denied, do not complete the transaction and follow any instructions from the Authorization Center;
- (c) not divide a single transaction between two or more Sales Slips but may divide a single transaction between an HSBC Sales Slip and a sales slip for another credit provider provided that: (a) the HSBC credit line is fully exhausted prior to another credit provider's credit line being used for the single transaction; (b) Merchant only allows the non-HSBC funded portion of the Sales Slip to be placed on a line of credit that was in existence prior to the start of the transaction; and, (c) Merchant makes all commercially reasonable efforts to match up product groups and sets on the same credit line.
- (d) if applicable, imprint legibly on the Sales Slip the embossed legends from the Card or if the transaction is to be completed electronically or otherwise without a Card imprint, then enter legibly on the Sales Slip sufficient information to identify the Cardholder and Merchant, including at least, Merchant's name and address, the Cardholder's name, Account number and the effective date, if any, on the Card. Merchant shall be deemed to warrant the Cardholder's true identity as an authorized user of the Card;

- (e) for in store sales, obtain the signature of the Cardholder on the Sales Slip, compare the signature on the Sales Slip with the signature panel of the Card, and if identification is uncertain or if Merchant otherwise questions the validity of the Card, contact HSBC's Authorization Center for instructions. For telephone orders (TO), mail orders (MO), or internet orders (IO), the Sales Slip may be completed without the Cardholder's signature and a Card imprint, but Merchant shall, in addition to all other requirements under this Section 5.5, enter legibly on the signature line of the Sales Slip the letters TO, MO, or IO, as appropriate, and not provide Goods after being advised that the TO, MO, or IO has been canceled or that the Card is not to be honored;
- (f) **BE RESPONSIBLE FOR THE IDENTIFICATION OF THE CARDHOLDER;**
- (g) not present the Sales Slip to HSBC for funding until all Goods are provided to the Cardholder's reasonable satisfaction. If the Card Sale is canceled or the Goods canceled or returned the Sales Slip is subject to Chargeback;
- (h) enter the Card Sale into the Terminal; and
- (i) except with respect to telephone orders, mail orders, and internet orders, deliver a true and completed copy of the Sales Slip to the Cardholder at the time of delivery of the Goods.

#### **Section 5.6 Credit Slips.**

Merchant shall not make any cash refund but shall complete and deliver promptly to HSBC a Credit Slip evidencing a refund or adjustment and deliver to the Cardholder a true and complete copy of the Credit Slip at the time the refund or adjustment is made if Goods are returned, any Card Sale is terminated or canceled, or Merchant allows any price adjustment. Merchant shall sign and date each Credit Slip and include thereon a brief description of the Goods returned, Card Sale terminated or canceled, or adjustment made, the date of the original Card Sale, Authorization number, Cardholder's name, address and Account number, and the date and amount of the credit, all in sufficient detail to identify the transaction. Merchant shall imprint or legibly reproduce on each Credit Slip the embossed legends from the Card. The amount of the Credit Slip cannot exceed the amount of the original transaction as reflected on the Sales Slip. Merchant shall issue Credit Slips only in connection with previous bona fide Card Sales and only as permitted hereunder.

#### **Section 5.7 Acceptance, Offset and Funding.**

Subject to the terms, conditions, warranties and representations in this Agreement and provided that Merchant has satisfied all of the conditions set forth in this Agreement, HSBC agrees to pay to Merchant the amount of each valid and authorized Sales Slip or Card Sale presented to HSBC during the term of this Agreement, less the amount of the fees, charges, and discounts described below, outstanding Account balances for Sales Slips subject to Chargeback, reimbursements, refunds, customer credits and any other amounts owed to HSBC by Merchant under this Agreement. HSBC may also offset or recoup said amounts from future amounts owed to Merchant under this Agreement. Any amounts owed by Merchant to HSBC that cannot be paid by the aforesaid means shall be due and payable by Merchant on demand. If Merchant fails or refuses to pay any amounts owed to HSBC under this Agreement after HSBC's demand, HSBC may cease authorizations for and the funding or acceptance of any Sales Slips or Card Sales or the processing of applications for an Account. Any payment made by HSBC to Merchant shall not be final but shall be subject to subsequent review and verification by HSBC. HSBC's liability to Merchant with respect to the funding or processing of any Card Sale, Sales Slip or Credit Slip shall not exceed the amount on the Sales Slip or Credit Slip in connection with such transaction. In no event shall HSBC be liable to Merchant for any incidental or consequential damages associated with the funding or processing of or the failure to fund or process any Sales Slip, Card Sale, or Credit Slip. Funding of Sales Slips by HSBC to Merchant shall be made by such means and in such manner mutually agreed to by HSBC and Merchant.

Merchant acknowledges and agrees (i) that HSBC is paying Merchant for Sales Slips in advance before HSBC can determine whether such Sales Slips are subject to Chargeback, (ii) as a result, HSBC's payment to Merchant is conditioned upon, and reliance on, Merchant's agreement to permit HSBC to recoup Chargebacks and other overpayments from fundings payable to Merchant under this Agreement for subsequently presented Sale Slips, and (iii) due to the ongoing reconciliation process implemented under this Agreement, the reduction of current fundings by the amount of Chargebacks and other amounts owing by Merchant to HSBC constitutes a single integrated transaction.

#### **Section 5.8 Cardholder Payments and Endorsement.**

Merchant agrees that HSBC has the sole right to receive payments on any Sales Slip or Card Sale funded by HSBC. Unless specifically authorized in writing by HSBC, Merchant agrees not to make any collections on any such Sales Slips or Card Sale. Merchant may not knowingly receive payments on any Sales Slip or Card Sale at any of its locations. In the event a payment is inadvertently received by Merchant, Merchant agrees to hold such payment in trust for HSBC and to deliver any such payment to HSBC together with the Cardholder's name, Account number, and any correspondence accompanying the payment within five (5) days of receipt by Merchant. Merchant agrees that Merchant shall be deemed to have endorsed any Sales Slip, Credit Slip, or Cardholder payments by check, money order, or other instrument made payable to Merchant that a Cardholder presents to HSBC in HSBC's favor, and Merchant hereby authorizes HSBC to supply such necessary endorsements on behalf of Merchant. Merchant shall not receive any payments from a Cardholder to prepare and present a Credit Slip for the purpose of effecting a credit to the Cardholder's Account.

#### **Section 5.9 Written Complaints.**

Merchant shall within three (3) business days of receipt provide HSBC with a copy of any written complaint from any Cardholder concerning an Account.

#### **Section 5.10 Operating Instructions.**

Merchant shall satisfy all other requirements designated in any Operating Instructions by HSBC, including, but not limited to, procedures and guidelines relating to cash transactions. HSBC shall provide Merchant reasonable prior notice if there are any changes in the Operating Instructions. In the event there is any inconsistency between any Operating Instructions and this Agreement, this Agreement shall govern unless otherwise expressly indicated by HSBC in any Operating Instructions.

#### **Section 5.11 Facsimile and E-Mail Communication.**

Merchant agrees to accept announcements, changes in Operating Instructions, and any other type of written material from HSBC at any time during the term of this Agreement via facsimile or e-mail transmission. Any notices affecting the terms of this Agreement must also be sent in accordance with Section 13.16 below.

#### **Section 5.12 Merchant Business Practices.**

Merchant agrees to provide adequate services in connection with each Card Sale pursuant to standard customs and trade practices and any applicable manufacturer's warranties, and to provide such repairs, service and replacements and take such other corrective action as may be required by Applicable Law or any applicable warranty.

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### **Section 5.13 Presentation of Sales Slip or Credit Slips.**

Merchant shall present each Sales Slip or Credit Slip to HSBC or such other entity designated by HSBC within five (5) Business Days after the date of the respective sale or credit transaction.

## **ARTICLE 6 - CHARGEBACKS TO MERCHANT**

### **Section 6.1 Right to Chargeback.**

Any Sales Slip or Card Sale is subject to Chargeback under any one or more of the following circumstances, and thereupon the provisions of Section 6.3 below shall apply:

- (a) the application or any information on the application or the Sales Slip or any required information on the Sales Slip is illegible or incomplete; the Sales Slip or application is not executed by the Cardholder;
- (b) an Authorization is not obtained from the Authorization Center;
- (c) the Sales Slip is a duplicate of a Sales Slip previously paid;
- (d) the price of the Goods shown on the Sales Slip differs from the amount shown on the Cardholder's copy of the Sales Slip;
- (e) HSBC reasonably determines that (i) Merchant has breached or failed to satisfy, any term, condition, covenant, warranty, or other provision of this Agreement, or of the Operating Instructions, in connection with a Sales Slip, Card Sale or the transaction to which it relates, or an application for a Card or the opening of an Account;
- (f) the Sales Slip, application, cardholder agreement or Card Sale is fraudulent or is subject to any claim of illegality, cancellation, rescission, avoidance or offset for any reason whatsoever, including, without limitation, negligence, fraud, misrepresentation, or dishonesty on the part of the customer or Merchant or its agents, employees, licensees, or franchisees;
- (g) the related transaction is not a bona fide transaction in Merchant's ordinary course of business;
- (h) the Cardholder in good faith, disputes or denies the Card Sale or other Card transaction, the execution of the Sales Slip, application, or Cardholder Agreement;
- (i) the Cardholder in good faith disputes or denies the delivery, quality, or performance of the Goods;
- (j) the Cardholder alleges that a credit adjustment was requested and refused or that a credit adjustment was issued by Merchant but not posted to the Account due to Merchant's failure to submit the Credit Slip to HSBC;
- (k) Merchant ships Goods to an address that does not match HSBC's billing address and the Cardholder denies that the Goods were received; or
- (l) Merchant fails to deliver to HSBC the Sales Slip, Credit Slip, application or other records of the Card transaction within the time periods required in this Agreement.

### **Section 6.2 Fraud Chargeback Exception.**

Notwithstanding anything to the contrary in Section 6.1, but subject to the limitation set forth in Section 6.2(b), HSBC and Merchant agree that where Merchant follows the terms and procedures and provides the information set forth below, except as provided in Section 5.4, HSBC may only chargeback the portion of the Card Sale or Sales Slip which is reasonably determined by HSBC to be the result of customer fraud that is equivalent to 50% of the Card Sale or Sales Slip. The liability of HSBC for all chargebacks is limited to an amount equivalent to 1% of annual Net Card Sales.

- (a) Merchant shall have complied with Sections 5.4(a) through 5.4(h) with respect to the transaction in question.

- (b) Within fifteen (15) Business Days of receipt of HSBC's request, or such earlier time as may be required by HSBC, Merchant shall provide to HSBC a copy of the signed application, signed Sales Slip, and, if the Goods are shipped, signed delivery receipt, and the signature on the application matches the signatures on the Sales Slip and, if the Goods are shipped, delivery receipt.
- (c) For Card Sales made to a Cardholder on the telephone or through the Internet, Merchant shall not have shipped for 24 hours after an approval to allow HSBC time to notify Merchant of suspected fraud after any appropriate fraud checks.
- (d) Merchant shall not have shipped to an address other than the billing address.
- (e) If Merchant has not yet shipped Goods, Merchant shall stop shipment when HSBC notifies Merchant that the transaction is suspected fraud.

### **Section 6.3 Resolution and Payment.**

Merchant is required to resolve any dispute or other of the circumstances described above in Section 6.1 to HSBC's reasonable satisfaction within twenty one (21) days of notice of Chargeback or Merchant shall pay to HSBC the full amount of each such Sales Slip or Card Sale subject to Chargeback or the portion thereof designated by HSBC, as the case may be, plus the finance charges thereon, and other fees and charges provided for in the Cardholder agreement. Upon Chargeback to Merchant of a Sales Slip or Card Sale, Merchant shall bear all liability and risk of loss associated with such Sales Slip or Account, or the applicable portion thereof, without warranty by, or recourse or liability to, HSBC. HSBC may deduct amounts owed to HSBC under this Section from any amounts owed to Merchant under this Agreement. HSBC shall be entitled to recover reasonable attorney fees incurred by HSBC to collect any Chargeback amounts due HSBC which are not paid by Merchant in accordance with the terms of the Agreement.

## **ARTICLE 7 – TRANSMISSION, RECORDS, AND REPORTS**

### **Section 7.1 Transmission of Data.**

In lieu of forwarding paper Sales Slips and Credit Slips to HSBC, Merchant shall transmit to HSBC, by electronic transmission or other form of transmission designated by HSBC all data required by this Agreement to appear on Sales Slips and Credit Slips. All data transmitted shall be in a medium, form and format mutually agreed to by HSBC and Merchant. Any errors in such data or in its transmission shall be the sole responsibility of Merchant. The means of transmission mutually agreed to shall be the exclusive means utilized by Merchant for the transmission of Sales Slip or Credit Slip transaction data to HSBC. If HSBC provides any hardware/software in the future in regards to data transmission, both parties will discuss amending this section.



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### **Section 7.2 Receipt of Transmission.**

Upon successful receipt of any transmission, HSBC shall accept such transmission and pay Merchant in accordance with this Agreement, subject to subsequent review and verification by HSBC and to all other rights of HSBC and obligations of Merchant as set forth in this Agreement. If data transmission is by tape, Merchant agrees to deliver upon demand by HSBC a duplicate tape of any prior tape transmission, if such demand is made within forty-five (45) days of the original transmission.

### **Section 7.3 Records.**

Merchant shall maintain any actual paper Sales Slips, Credit Slips, and other records pertaining to any transaction covered by this Agreement for such time and in such manner as HSBC or any law or regulation may require, but in no event less than two (2) years after the date Merchant presents each transaction data to HSBC, and Merchant shall make and retain for at least four (4) years legible copies of the actual paper Sales Slips, Credit Slips or other transaction records. Within fifteen (15) days, or such earlier time as may be required by HSBC, of receipt of HSBC's request, Merchant shall provide to HSBC the actual paper Sales Slips, Credit Slips or other transaction records, any other documentary evidence available to Merchant and reasonably requested by HSBC to meet its obligations under law (including its obligations under the Fair Credit Billing act) or otherwise to respond to questions, complaints, lawsuits, counterclaims or claims concerning Accounts or requests from Cardholders, or to enforce any rights HSBC may have against a Cardholder, including, without limitation, litigation by or against HSBC, collection efforts and bankruptcy proceedings, or for any other reason. In the event Merchant fails to comply in any respect with the provisions of this Section, HSBC may process a Chargeback for each Card Sale involved pursuant to Article 7 above. Promptly upon termination of this Agreement or upon the request of HSBC, Merchant will provide HSBC with all original and microfilm copies of documents required to be retained under this Agreement.

### **Section 7.4 Reporting by HSBC.**

HSBC shall provide Merchant with standardized monthly and quarterly reports. Merchant may also request ad hoc reports, but such requests shall be limited and provided by HSBC in its discretion.

## **ARTICLE 8 - HSBC REPRESENTATIONS AND WARRANTIES**

### **Section 8.1 General Representations and Warranties.**

HSBC represents and warrants to Merchant as of the Effective Date and throughout the term of this Agreement the following:

- (a) It has full corporate or other power and authority to enter into this Agreement; that all corporate or other action required under any organization documents to make this Agreement binding and valid upon HSBC according to its terms has been taken; and that this Agreement is and will be binding, valid and enforceable upon HSBC according to its terms.
- (b) Neither (i) the execution, delivery and performance of this Agreement, nor (ii) the consummation of the transactions contemplated hereby will constitute a violation of law or a violation or default by HSBC under its articles of incorporation, bylaws or any organization documents, or any material agreement or contract, and no authorization of any governmental authority is required in connection with the performance by HSBC of its obligations hereunder.
- (c) It has and will retain all licenses required by local or state law to conduct its business and to perform its obligations under this Agreement
- (d) It will comply with all Applicable Law.

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## **ARTICLE 9 - MERCHANT REPRESENTATIONS AND WARRANTIES**

### **Section 9.1 General Representations and Warranties.**

Merchant represents and warrants to HSBC as of the Effective Date and throughout the term of this Agreement the following:

- (a) It has full corporate or other power and authority to enter into this Agreement; that all corporate or other action required under any organization documents to make this Agreement binding and valid upon Merchant according to its terms has been taken; and that this Agreement is and will be binding, valid and enforceable upon Merchant according to its terms.
- (b) Neither (i) the execution, delivery and performance of this Agreement, nor (ii) the consummation of the transactions contemplated hereby will constitute a violation of law or a violation or default by Merchant under its articles of incorporation, bylaws or any organization documents, or any material agreement or contract, and no authorization of any governmental authority is required in connection with the performance by Merchant of its obligations hereunder.
- (c) It has and will retain all licenses required by local or state law to conduct its business and to perform its obligations under this Agreement.
- (d) It will comply with all Applicable Law.

### **Section 9.2 Representations and Warranties Regarding Card Sales and Applications.**

Merchant represents and warrants to HSBC as of the Effective Date and throughout the term of this Agreement the following:

- (a) Each Card Sale will arise out of a bona fide sale of Goods by Merchant and will not involve the use of the Card for any other purpose.
- (b) Each Card Sale will be to a consumer for personal, family, or household purposes.
- (c) Cardholder applications will be available to the public (i) without regard to race, color, religion, national origin, sex, marital status, disability or age (provided the applicant has the capacity to enter into a binding contract) and (ii) not in any manner which would discriminate against an applicant or discourage an applicant from applying for the Card.
- (d) It has developed, implemented and will maintain effective policies and procedures designed to detect relevant and applicable Red Flags as such Red Flags are defined by the final rules and guidelines that implement Section 114 of the Fair and Accurate Credit Transaction Act of 2003 (FACTA). Merchant shall report to HSBC the occurrence of applicable Red Flags regarding Cardholders and Card applicants, and take appropriate steps to prevent or mitigate identity theft of Cardholders and applicants. Red Flag processes and procedures will be triggered, as applicable in a particular transaction, where:
  - 1) Documents provided for identification at the point of application by a Card applicant appear altered or forged.
  - 2) The photograph or physical description on the identification is not consistent with the appearance of the Card applicant or Cardholder presenting the identification.
  - 3) Other information on the identification of the Card applicant is not consistent with information provided by the person presenting the identification.

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- 4) An application appears to have been altered or forged.
  - 5) The Card applicant opening the Account fails to provide all required personal identifying information on an application, or in response to notification that the application is incomplete.
  - 6) A new Account is used in a manner Merchant would reasonably associate with known patterns of fraud.

## **ARTICLE 10 - INDEMNIFICATION**

### **Section 10.1 Indemnification by Merchant.**

Merchant shall indemnify HSBC, its Affiliates, and their respective officers, employees, agents and directors (collectively, the “HSBC Indemnified Parties”) and hold the HSBC Indemnified Parties harmless, from any losses, damages, costs, expenses (including reasonable attorneys fees), liabilities, judgments, demands, offsets, defenses, counterclaims, actions, proceedings, claims or complaints incurred by any of the HSBC Indemnified Parties, regardless of the person, entity, or instrumentality making such assertion, arising out of: (i) Merchant’s failure to comply with this Agreement; (ii) anything done or not done by Merchant in connection with Card Sales, Card transactions or credits; (iii) anything done or not done by Merchant in connection with the furnishing of any Goods purchased by Cardholders; (iv) the death or injury to any person or the loss, destruction or damage to any property arising out of anything done or not done by Merchant in connection with the design, manufacture or furnishing by Merchant of any Goods purchased by Cardholders; (v) Merchant’s advertisements and promotions relating to the Program, credit terms or credit products which have not been approved by HSBC; (vi) any actual or alleged illegal or improper conduct of Merchant or its employees or agents in connection with any of the transactions contemplated by this Agreement; and (vii) any violation, or claimed violation, by Merchant of the Equal Credit Opportunity Act, Truth in Lending Act, or any other Applicable Laws.

### **Section 10.2 Indemnification by HSBC .**

HSBC shall be liable to and shall indemnify and hold harmless Merchant, its Affiliates, and their respective officers, employees, agents and directors (the “Merchant Indemnified Parties”) from any losses, damages, costs, expenses (including reasonable attorneys fees), liabilities, judgments, demands, offsets, defenses, counterclaims, actions, proceedings, claims or complaints incurred by any of the Merchant Indemnified Parties, regardless of the person, entity, or instrumentality making such assertion, arising out of (i) HSBC’s failure to comply with this Agreement; (ii) anything done or not done by HSBC in connection with such Cardholder’s Account; (iii) any actual or alleged illegal or improper conduct of HSBC, or its employees or agents with respect to the Card, a Card Sale, an Account or any other matters relating to the Program; (iv) any violation, or claimed violation, by HSBC , with respect to the application or agreement, or the Equal Credit Opportunity Act, Truth in Lending Act or any other Applicable Laws; and (v) the Operating Instructions, advertisements, and promotions prepared by HSBC relating to the Program, credit terms or credit products. Notwithstanding the foregoing, the indemnification by HSBC shall not apply to any claim or complaint relating to the failure of Merchant to resolve a billing inquiry or dispute with a Cardholder relating to Goods or services purchased on an Account where such failure was not caused by HSBC.

### Section 10.3 Notice of Claim.

In the event that HSBC or Merchant know of any facts which would lead to a claim or demand, receive a claim or demand, or be subject to any suit or proceeding, of which a claim may be made against the other under this Section (other than a claim, demand, suit or proceeding by a party to this Agreement against the other party to this Agreement that has not been initiated), the indemnified party shall give prompt written notice thereof to the indemnifying party and the indemnifying party will be entitled to participate in the settlement or defense thereof with counsel satisfactory to indemnified party at the indemnifying party's expense. In any case, the indemnifying party and the indemnified party shall cooperate (at no cost to the indemnified party) in the settlement or defense of any such claim, demand, suit, or proceeding.

## ARTICLE 11 - TERM AND TERMINATION

### Section 11.1 Term.

This Agreement shall be effective as of the Effective Date when executed by authorized officers of each of the parties. It shall remain in effect until December 31, 2013 ("Initial Term"), and shall thereafter be automatically renewed for successive two (2) year terms (each a "Renewal Term") unless and until terminated as provided herein. The termination of this Agreement shall not affect the rights and obligations of the parties with respect to transactions and occurrences that take place prior to the effective date of termination, except as otherwise provided herein.

### Section 11.2 Termination.

This Agreement may be terminated:

- (a) effective at the end of the Initial Term or any Renewal Term, by HSBC or Merchant upon not less than one hundred and eighty (180) days prior written notice to the other prior to the end of such term;
- (b) by HSBC upon written notice to Merchant if the aggregate dollar amount of all Sales Slips subject to Chargeback in any monthly billing cycle exceeds \*% of the total net balances of all Accounts at the end of such monthly billing cycle, or if Sales Slips subject to Chargeback account for \*% of total sales in any two consecutive calendar quarters.
- (c) by HSBC or Merchant upon written notice to the other in the event the other party (i) shall elect to wind up or dissolve its operation or is wound up and dissolved; (ii) becomes insolvent or repeatedly fails to pay its debts as they become due; (iii) makes an assignment for the benefit of creditors; (iv) files a voluntary petition in bankruptcy, or for reorganization or is adjudicated as bankrupt or insolvent; (v) has a liquidator or trustee appointed over its affairs; (vi) suffers a material adverse change in its financial condition as reasonably determined by the terminating party in that party's sole discretion; (vii) suspends or goes out of business or substantially reduces its business operations or sends a notice of a proposed bulk sale of all or part of its business; (viii) materially breaches its obligations or any warranty or representation under this Agreement; or (ix) as reasonably determined by the terminating party, will not be able to perform its obligations under this Agreement; and

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\* Certain information on this page has been omitted and filed separately with the Securities and Exchange Commission. Confidential treatment has been requested with respect to the omitted portions.

- (d) by HSBC upon written notice to Merchant (i) if there occurs any material change in ownership of Merchant greater than \* percent (\*%); (ii) if HSBC receives a disproportionate number of Cardholder inquiries, disputes, or complaints defined as Accounts from which disputes are received in excess of \* % of accounts with balances during any two successive quarters; or (iii) if in HSBC's judgment, any Applicable Law requires that this Agreement or either party's rights or obligations hereunder be amended, modified, waived or suspended in any material respect, including, without limitation, the amount of finance charges or fees that may be charged or collected or the consumer rate that may be charged on purchases with the Account; provided, however, that either party provides thirty (30) days written notice if it intends to exercise its right under Section 11. 2(d)(i) or (ii).
- (e) by either party without penalty on written notice, after ninety (90) days of the other party's performance hereunder being prevented or materially impeded, without the ability to cure, by an event of force majeure as set forth in Section 13.14.

### **Section 11.3 Duties and Rights Upon Termination.**

Upon termination of this Agreement, Merchant shall promptly submit to HSBC all Card Sales, Sales Slips, Credit Slips and other transaction documents or data made through the date of termination. In addition, Merchant shall promptly return all computer hardware and software, remote data entry terminals and peripherals and other equipment provided by HSBC in good working order and Merchant shall de-install from its operating system any program files provided by HSBC to Merchant. HSBC is not liable to Merchant for any direct or consequential damages that Merchant may suffer as a result of HSBC's termination of this Agreement.

### **Section 11.4 Survival.**

The terms and provisions of Articles 6, 7, 8, 9, 10, 12, and Sections 5.6, 11.3, 13.3, 13.4, 13.5, 13.6, 13.7, 13.8, 13.9, 13.10, 13.23, 13.24, and 13.25 shall survive termination of this Agreement.

## **ARTICLE 12 - LETTER OF CREDIT**

### **Section 12.1 Letter of Credit**

On or before January 1, 2009, Merchant shall provide a letter of credit ("Letter of Credit") to HSBC from Merchant's bank in form and content satisfactory to HSBC in the amount of \* (\$\*). In the event Merchant does not pay HSBC any amounts due hereunder when due, including amounts due for Chargebacks, HSBC may draw upon the Letter of Credit to cover amounts owing to HSBC. Merchant shall also hereafter execute such documents and take such other actions as HSBC reasonably determines necessary in order to permit HSBC to draw on the Letter of Credit. Merchant hereby authorizes its issuing bank to comply with all instructions from HSBC with respect to the Letter of Credit, without further consent or direction from Merchant. The amount and terms of the Letter of Credit shall be reviewed semi-annually by the parties. The Letter of Credit may be withdrawn no sooner than one year after termination of this Agreement.

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\* Certain information on this page has been omitted and filed separately with the Securities and Exchange Commission. Confidential treatment has been requested with respect to the omitted portions.

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## **ARTICLE 13 - MISCELLANEOUS**

### **Section 13.1 Merchant Financial Information.**

HSBC may annually review Merchant's financial stability. To assist HSBC in doing this, Merchant shall deliver to HSBC no later than 45 days after the end of each fiscal quarter, a financial statement certified by a duly authorized officer or representative of Merchant with knowledge of the accuracy of the information contained therein, including, without limitation, all footnotes, and supporting materials with sufficient detail to accurately portray the financial condition of Merchant. Merchant warrants and represents that its financial statements submitted to HSBC by or on behalf of Merchant are true and accurate and Merchant agrees to supply such additional financial information as HSBC may reasonably request from time to time. Merchant understands that HSBC may verify the information on any financial statement or other information provided by Merchant and, from time to time, may seek credit and other information concerning Merchant from others and may provide financial and other information regarding the portfolio to its Affiliates or to others for purposes of its asset securitizations and sales.

### **Section 13.2 Securitization.**

HSBC shall have the right to securitize the portfolio or any part thereof by itself or as part of a larger offering at any time. Such a securitization shall not affect Merchant's rights or HSBC's obligations with respect to customer service, payment processing, and collections. However, HSBC shall not securitize the Accounts in any manner that may encumber Merchant's, or its third party designee's, right to purchase the Accounts upon termination.

### **Section 13.3 Limited License**

Merchant hereby authorizes HSBC for purposes of this Agreement to use Merchant's Proprietary Designations on the Cards, applications, periodic statements, billing statements, collection letters or documents, promotional or advertising materials and otherwise in connection with the Program, subject to Merchant's periodic reasonable review of such use and to such reasonable specifications of Merchant. Merchant represents and warrants that it has obtained appropriate federal and state trademark registrations to protect its interest in the use and ownership of its Proprietary Designations. Merchant shall, indemnify, defend and hold HSBC harmless from any loss, damage, expense or liability arising from any claims of alleged infringement of its Proprietary Designations (including reasonable attorneys' fees and costs). Merchant may not use any name or service mark of HSBC or any of its Affiliates in any manner without the prior written consent of HSBC .

### **Section 13.4 Material Inducement**

Merchant acknowledges and agrees that HSBC is specifically relying on the agreements, representations, warranties and waivers contained herein and that such agreements, representations warranties and waivers constitute a material inducement to HSBC to accept this Agreement and to enter into the transactions contemplated herein.

### **Section 13.5 Confidentiality**

Merchant will keep confidential and not disclose to any person or entity (except to employees, officers, partners or directors of Merchant who are engaged in the implementation and execution of the Program) and shall use, or cause to be used, such Confidential Information solely for the purposes of the performance of Merchant's obligations under the terms of this Agreement. Further, each party shall keep confidential and not disclose to any person or entity (except employees, officers, agents or

directors of that party or its Affiliates who are engaged in the implementation and execution of the Program) this Agreement and any information that party receives from the other party which is designated confidential by the other party. In the event HSBC sells or assigns the Accounts or any portion of the Accounts under the Program, unless prohibited by law, HSBC may disclose any Confidential Information under this provision reasonably necessary or required to effectuate such sale or assignment.

Notwithstanding anything to the contrary, each party to this Agreement (and each employee, representative or other agent for each party to this Agreement for so long as they remain an employee, representative or agent) may disclose to any and all persons, without limitation of any kind, the tax treatment and tax structure of the transactions contemplated by the Agreement and all materials of any kind (including opinions or other tax analyses) that are provided to each party relating to such tax treatment or tax structure. The preceding sentence shall be effective immediately upon the commencement of discussions between the parties (whether such discussions commenced verbally, in writing or otherwise) that are related to the terms of this Agreement.

The obligations set out herein do not apply to HSBC Holdings plc ("HSBC Holdings") nor any subsidiary or division thereof other than HSBC, except to the extent that HSBC Holdings staff or staff within such other subsidiary or division receive Confidential Information from HSBC, in which such case the obligations set forth herein will upon and from the date of such receipt be taken to apply to HSBC Holdings or any such other subsidiary or division.

#### **Section 13.6 Information Security**

Merchant has developed, implemented, and will maintain effective information security policies and procedures that include administrative, technical and physical safeguards designed to 1) ensure the security and confidentiality of Confidential Information provided to Merchant hereunder, 2) protect against anticipated threats or hazards to the security or integrity of such Confidential Information, 3) protect against unauthorized access or use of such Confidential Information, and (4) ensure the proper disposal of Confidential Information. All Merchant personnel handling such Confidential Information have been appropriately trained in the implementation of Merchant's information security policies and procedures. Merchant regularly audits and reviews its information security policies and procedures to ensure their continued effectiveness and determine whether adjustments are necessary in light of circumstances including, without limitation, changes in technology, customer information systems or threats or hazards to Confidential Information.

#### **Section 13.7 Privacy.**

Merchant shall not make any unauthorized disclosure of or use any personal information of individual consumers which it receives from HSBC or on HSBC's behalf other than to carry out the purposes for which such information is received, and Merchant and HSBC shall comply in all respects with all applicable requirements of Title V of the Gramm-Leach-Bliley Act of 1999 and its implementing regulations.

#### **Section 13.8 Reports; Examination Rights.**

Merchant shall keep an accurate record of all transactions that occur under this Agreement. HSBC or its agent may examine, at HSBC's expense, the books and records of Merchant that are relevant to this Agreement. Any such examination will be conducted during normal business hours upon no less than ten (10) days advance written notice to Merchant. Merchant will cooperate fully with HSBC and/or

its agent and allow inspection of its relevant books and records in order to review and assess Merchant performance of and compliance with the terms of this Agreement including, without limitation, the sufficiency of Merchant information security policies and procedures with respect to HSBC's Confidential Information. In evaluating the sufficiency of Merchant's information security policies and procedures, HSBC shall be provided access to reports of audits, tests and/or other evaluations of Merchant's information security policies and procedures conducted by Merchant in the ordinary course of its business.

### **Section 13.9 Regulatory Examinations**

Merchant acknowledges that HSBC may be subject to audit and examination by governmental regulatory authorities. Merchant agrees to provide access to the books and records that pertain to HSBC's relationship with Merchant, upon being granted a reasonable period of time to do so, to any such governmental regulatory authority, upon the request of such authority or of HSBC for that purpose. All examinations conducted hereunder by HSBC, its agent, or its governmental regulatory authority shall be at the expense of HSBC.

### **Section 13.10 Merchant's Agents.**

In the event Merchant desires that HSBC provide a third party access to certain Program information of HSBC to which Merchant is otherwise entitled in connection with this Agreement, Merchant shall direct and authorize HSBC to do so, but before HSBC is obligated to do so, the following must occur: (a) Merchant shall enter into a written agreement with that third party pursuant to which that third party shall agree to act as Merchant's agent in receiving information provided by HSBC, to only use such information as Merchant's agent in connection with the Program and for no other reason, to use such information and to otherwise act in compliance with applicable law, including, without limitation, the Gramm-Leach Bliley Act of 1999 and its implementing regulation; (b) Merchant shall provide a copy of such agreement to HSBC; (c) Merchant shall cause such agent to use any such information in accordance with the aforementioned agreement; and (d) such agent shall be required to enter into an agreement with HSBC which contains confidentiality provisions and other terms governing the provision of such information to that agent. Notwithstanding HSBC's agreement with such agent, Merchant shall be responsible for the acts of that agent.

### **Section 13.11 Change in Ownership.**

Merchant agrees to send HSBC at least thirty (30) days' prior written notice of any change in Merchant's name or location, any material change in ownership of Merchant's business or any change in Sales Slip or Credit Slip information concerning Merchant.

### **Section 13.12 Nonwaiver.**

Merchant's liability under this Agreement, including, without limitation, its liability under Section 13.7 above, shall not be affected by any settlement, extension, forbearance, or variation in terms that HSBC may grant in connection with any Sales Slip or Account or by the discharge or release of the obligations of the Cardholder(s) or any other person by operation of law or otherwise. Merchant hereby waives any failure or delay on HSBC's part in asserting or enforcing any right that HSBC may have at any time under this Agreement or under any Account.



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**Section 13.13 Status of the Parties.**

In performing their responsibilities pursuant to this Agreement, HSBC and Merchant are in the position of independent contractors, and in no circumstances shall either party be deemed to be the agent or employee of the other. This Agreement is not intended to create, nor does it create and shall not be construed to create, a relationship of principal and agent, partner or joint venturer or an association for profit between HSBC or Merchant. Any amounts ever owing by Merchant pursuant to this Agreement represent contractual obligations only and are not a loan or debt.

**Section 13.14 Force Majeure.**

Neither party to this Agreement shall be liable to the other by reason of any failure in performance of this Agreement in accordance with its terms if such failure arises out of a cause beyond the control and without the fault or negligence of such party. Such causes may include but are not limited to acts of God, of the public enemy or of civil or military authority, unavailability of energy resources, system or communication failure, delay in transportation, fires, strikes, riots or war. In the event of any force majeure occurrence, the disabled party shall use its best efforts to meet its obligations as set forth in this Agreement.

**Section 13.15 Additional Products and Services.**

HSBC and/or any of its Affiliates may at any time, whether during or after the term of this Agreement and whether the Accounts are owned by HSBC, solicit Cardholders for any other credit cards or other types of accounts or financial or insurance services or products offered by HSBC and/or any of its Affiliates.

**Section 13.16 Notices.**

All notices required or permitted by this Agreement shall be in writing and shall be sent to the respective parties as follows:

**If to HSBC:**

HSBC Bank Nevada, National Association  
2700 Sanders Rd.  
Prospect Heights, IL 60070  
Attention: Managing Director – Retail Services

With a copy to:

HSBC Retail Services Law Department  
2700 Sanders Road  
Prospect Heights, Illinois 60070  
Attention: General Counsel – Retail Services

**If to Merchant:**

Nautilus, Inc.  
16400 SE Nautilus Dr.  
Vancouver, Washington 98683  
Attn: Director of Legal Affairs

or such other addresses as each party may designate to the other by notice hereunder. Said notices shall be deemed to be received when sent to the above addresses (i) upon three (3) Business Days after deposit in the U.S. first class mail with postage prepaid, (ii) upon personal delivery, or (iii) upon receipt by telex, facsimile, or overnight/express courier service or mail.

#### **Section 13.17 Amendments and Supplementary Documents.**

Reference herein to “this Agreement” shall include any schedules, appendices, exhibits, and amendments hereto. HSBC may amend this Agreement upon ten (10) days’ prior written notice to Merchant if such modification is reasonably determined by HSBC to be required by any state or federal law, rule, regulation, governmental or judicial order, opinion, interpretation or decision. Any amendment or modification to this Agreement must be in writing and signed by a duly authorized officer of HSBC and Merchant to be effective and binding upon the parties; no oral amendments or modifications shall be binding upon the parties.

#### **Section 13.18 Assignment.**

This Agreement is binding upon the parties and their successors and assigns. Notwithstanding, Merchant may not assign this Agreement without the prior written consent of HSBC. Any merger, consolidation, transfer of assets or other transfer of control (defined to be a transfer on a cumulative basis of more than 25% of voting control) shall be deemed to be an assignment expressly prohibited by this Section 13.18 without the prior written consent of HSBC. Any purported assignment without such consent shall be void. HSBC may without Merchant’s consent assign this Agreement or any of the rights or obligations hereunder to any Affiliate of HSBC at any time. In the event of such assignment, the assignee shall have the same rights, remedies and obligations as HSBC under this Agreement.

#### **Section 13.19 Nonwaiver and Extensions.**

HSBC shall not by any act, delay, omission, or otherwise be deemed to have waived any rights or remedies hereunder. Merchant agrees that HSBC’s failure to enforce any of its rights under this Agreement shall not affect any other right of HSBC or the same right in any other instance.

#### **Section 13.20 Rights of Persons Not a Party.**

This Agreement shall not create any rights on the part of any person or entity not a party hereto, whether as a third party beneficiary or otherwise.

#### **Section 13.21 Section Headings.**

The headings of the sections of this Agreement are for reference only, are not a substantive part of this Agreement and are not to be used to affect the validity, construction or interpretation of this Agreement or any of its provisions.

#### **Section 13.22 Integrations.**

This Agreement contains the entire agreement between the parties. There are merged herein all prior oral or written agreements, amendments, representations, promises and conditions in connection with the subject matter hereof. Any representations, warranties, promises or conditions not expressly incorporated herein shall not be binding on HSBC.

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**Section 13.23 Governing Law/Severability.**

This Agreement shall be governed by and construed in accordance with the laws of the State of Nevada, without regard to the conflicts of law principles of Nevada. If any provision of this Agreement is contrary to Applicable Law, such provision shall be deemed ineffective without invalidating the remaining provisions hereof.

**Section 13.24 Jurisdiction.**

ANY SUIT, COUNTERCLAIM, ACTION OR PROCEEDING ARISING OUT OF OR RELATING TO THIS AGREEMENT MUST BE BROUGHT BY THE PARTIES SOLELY IN THE COURTS OF THE STATE OF ILLINOIS OR IN THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF ILLINOIS. MERCHANT AND HSBC HERBY IRREVOCABLY SUBMIT TO THE EXCLUSIVE JURISDICTION OF SUCH COURTS AND ANY APPELLATE COURTS THEREOF FOR THE PURPOSE OF ANY SUCH SUIT, COUNTERCLAIM, ACTION, PROCEEDING OR JUDGMENT (IT BEING UNDERSTOOD THAT SUCH CONSENT TO THE EXCLUSIVE JURISDICTION OF SUCH COURTS WAIVES ANY RIGHT TO SUBMIT ANY DISPUTES HEREUNDER TO ANY COURTS OTHER THAN THOSE ABOVE).

**Section 13.25 WAIVER OF JURY TRIAL.**

HSBC AND MERCHANT HEREBY KNOWINGLY, VOLUNTARILY AND INTENTIONALLY WAIVE ANY RIGHT TO A TRIAL BY JURY IN ANY ACTION, SUIT, PROCEEDING OR COUNTERCLAIM CONCERNING ANY RIGHTS UNDER THIS AGREEMENT, ANY RELATED DOCUMENT OR UNDER ANY OTHER DOCUMENT OR AGREEMENT DELIVERED OR WHICH MAY IN THE FUTURE BE DELIVERED IN CONNECTION HERewith OR THEREWITH, OR ARISING FROM ANY RELATIONSHIP EXISTING IN CONNECTION WITH THIS AGREEMENT, AND AGREE THAT ANY SUCH ACTION, SUIT, PROCEEDING OR COUNTERCLAIM SHALL BE TRIED BEFORE A COURT AND NOT BEFORE A JURY; THIS PROVISION IS A MATERIAL INDUCEMENT FOR HSBC AND MERCHANT ENTERING INTO THIS AGREEMENT.



## FINANCIAL TERMS

**Discounts**

The base discount fees shall be as follows:

<b>Standard Credit Program</b>	<b>Discounts</b>	<b>Multiplier</b>
Standard Revolving	*0%	*
3 month SAC/Delayed Monthly Payments	*0%	*
6 month SAC/Monthly Payments	*0%	*
12 month SAC/Monthly Payments	*0%	*
6 month Waived Finance Charge/Delayed Monthly Payments	*0%	*
12 month Waived Finance Charge/Delayed Monthly Payments	*0%	*
16.99% Reduced Rate/Fixed Payments	*0%	*

  

<b>Extended Credit Program</b>	<b>Discounts</b>	<b>Multiplier</b>
Standard Revolving	*0%	*
3 month SAC/Delayed Monthly Payments	*0%	*
6 month SAC/Monthly Payments	*0%	*
12 month SAC/Monthly Payments	*0%	*
6 month Waived Finance Charge/Delayed Monthly Payments	*0%	*
12 month Waived Finance Charge/Delayed Monthly Payments	*0%	*
16.99% Reduced Rate/Fixed Payments	*0%	*

The Promotional Credit Plan discount fees shall be adjusted based upon changes in LIBOR and the Liquidity Spread. The new Promotional Credit Plan discount fees shall be determined and adjusted on each Adjustment Date. The new Promotional Credit Plan discount fees shall be effective as to all Credit Promotion volume accepted and funded by HSBC for the next three (3) months starting immediately after the applicable Adjustment Date.

The new Promotional Credit Plan discount fees shall be determined by adding or subtracting the LIBOR Adjustment and the Liquidity Spread Adjustment to or from the base Promotional Credit Plan discount fee for each Credit Promotion.

Example – 6 Months Standard Credit Program SAC/Monthly Payments Credit Promotion

If the Current LIBOR on the Adjustment Date is \*% and the Base LIBOR was \*%, and if the Current Liquidity Spread on the Adjustment Date is \*i% and the Base Liquidity Spread was \*%, the discount fee would be calculated as follows:

1. \*% (Current LIBOR) minus \*% (Base LIBOR) = \*% (LIBOR Spread); \* (Multiplier for a 6 Month Standard SAC/MP promotion) times \*% (LIBOR Spread) = \* % (LIBOR Adjustment)
2. \*% (Current Liquidity Spread) minus \*% (Base Liquidity Spread) = \*% (Liquidity Spread); \*(Multiplier for a 6 Month Standard SAC/MP promotion) times \*% (Liquidity Spread) = \*% (Liquidity Spread Adjustment).
3. \*% (6 Month Standard SAC/MP promotion base discount fee) + \*% (LIBOR Adjustment) + \*% (Liquidity Spread Adjustment) = \*% (new discount fee for 6 Month Standard SAC/MP promotion).

\* Certain information on this page has been omitted and filed separately with the Securities and Exchange Commission. Confidential treatment has been requested with respect to the omitted portions.

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Notwithstanding the foregoing, the discount fees for the Standard Plan and all Promotional Credit Plans shall never be lower than 0%.

Merchant shall be entitled to a refund of the discount fees if the Card Sale is canceled or the Goods are returned or canceled within thirty (30) days of the date of the Card Sale. There shall be no refund of the discount fees if the Card Sale is canceled or the Goods are returned or canceled thirty (30) days or more after the date of the Card Sale.”

**Application Approval Rates.**

HSBC will notify Merchant of any significant changes that impact approval rates for the Program and, at Merchant’s request, discuss those changes with Merchant.

**SALES, GROSS RECEIPTS, AND PRIVILEGE TAX REFUNDS, DEDUCTIONS, AND CREDITS**

**I. Applicability.** Merchant agrees that HSBC or Merchant may file claims for refund (“Refunds”) or claim deductions, credits, amended returns or audit offsets (collectively, “Credits”) with respect to sales tax, gross receipts tax, transaction privilege tax, or other similar tax imposed on sales of tangible property with respect to any Accounts in states (and local jurisdictions) in which HSBC and Merchant mutually agree (i) the balances of which have been charged off by HSBC for federal income tax purposes, (ii) which were or are owned by HSBC, and (iii) which were originated with customers of Merchant who financed their retail purchases through HSBC, or through another lender and the Account was acquired by HSBC (“Mutual Claims”). This agreement shall apply to all Refunds or Credits filed or claimed on or after the Effective Date. Except as is otherwise provided in this Agreement, all Accounts that are the subject of this Schedule 2.10 were either acquired or originated by HSBC or received by HSBC by assignment without recourse. In the event of a termination of this Agreement, all Mutual Claims filed or pending prior to such termination shall continue to be processed and governed by the terms of this Schedule 2.10 (a Mutual Claim is pending with respect to an Account if the Account has been charged off by HSBC prior to or after the termination of this Agreement, but no Mutual Claim has been filed as of the date of termination of this Agreement with respect to such Account).

**II. Assignment.** With respect to claims for Refunds or Credits in states (and local jurisdictions) in which HSBC is the lead claimant (including, but not limited to, California, Indiana, and Washington), Merchant hereby assigns its right to any bad debt sales or use, gross receipts, transaction, privilege or other tax refunds, deductions or credits to HSBC with respect to all Accounts charged off relating to sales made in such states.

**III. Agreement to Pursue Mutual Claims.** HSBC and Merchant shall mutually agree upon the states in which Mutual Claims are to be filed. In the event Merchant elects to not participate for a particular period or in a particular state, HSBC may elect to pursue such Refund or Credit for its own account for such period or state and HSBC shall be entitled to all proceeds received from such Refund or Credit.

**IV. Determination of Claimant and Method of Pursuing Mutual Claims.** The determination of the party filing the Refund or claiming the Credit in a particular state shall be made by mutual agreement of HSBC and Merchant. The determination of whether the Mutual Claim shall be pursued as a Refund or Credit shall be made by mutual agreement of HSBC and Merchant.

**V. Preparation and Filing of Mutual Claims.** HSBC shall prepare all Mutual Claims for filing regardless of the identity of the claimant. Merchant will work expeditiously with HSBC to ensure that no Mutual Claims will be lost or denied due to the expiration of any statute of limitations. If the Mutual Claim is a Credit, HSBC shall provide the documentation supporting the Credit in spreadsheet format to Merchant, and Merchant shall file the return or amended returns on which the Credit shall be taken. Merchant shall provide to HSBC the taxable sales percentage from Merchant’s sales tax returns (taxable sales divided by total sales for such state) for each state and period with respect to which a Mutual Claim will be filed and any other information that is requested by HSBC or a state (including but not limited to information contained in Merchant’s state or federal income tax returns or from Merchant’s computer systems) within 60 days after HSBC or the state

requests such information. If a Refund is to be claimed in any state that requires an election or other written form to be filed as a condition to receiving a Refund, Merchant agrees to provide and execute such form that satisfies such state's requirement regarding Merchant and all of Merchant's retailers that are Affiliates of Merchant. If a state contacts either party with respect to any Mutual Claim, such party shall (i) provide prompt written notice of such event to the other party, (ii) provide copies of all correspondence and documents received from the state to the other party with respect to such Mutual Claim and (iii) consult with the other party prior to engaging in discussions with any state or providing any information (including Confidential Information) to any state regarding the Mutual Claims.

**VI. Audits of Mutual Claims.** If either party receives a notice of audit from a state, such party shall (i) provide written notice to the other party and (ii) provide copies of all correspondence received from the State to the other party with respect to such Mutual Claim. HSBC and Merchant shall jointly defend the audit through mutually agreeable means. Both parties shall consult with the other party prior to engaging in discussions with any state or providing any information (including Confidential Information) to any state regarding the audit of any Mutual Claim.

**VII. Litigation With Respect To Denied or Assessed Mutual Claims.** In the event a Mutual Claim is assessed or denied, HSBC and Merchant shall mutually determine whether to appeal such denial through the state administrative appeals process and, if applicable, to court.

**VIII. Proceeds of Refunds and Credits.** HSBC and Merchant shall each bear their own internal and external costs in connection with all Mutual Claims, including the fees and expenses of all outside consultants and attorneys. Merchant and HSBC agree that the Merchant shall receive twenty-five percent (25%) and HSBC shall receive seventy-five (75%) of the gross amount (including interest) of the Refunds received or Credits claimed with respect to Mutual Claims (the "Sharing Percentage"). A party receiving a Refund shall retain its Sharing Percentage and shall pay to the other party, in cash or by check, the other party's Sharing Percentage within thirty (30) days of receipt. In the event the party receiving the Refund fails to pay the Sharing Percentage to the other party within such thirty (30) day period, the party receiving the Refund shall also pay interest to the other party on the other party's Sharing Percentage at the rate of 1% per month until paid. If Merchant claims a Credit, Merchant shall retain its Sharing Percentage and shall pay to HSBC, in cash or by check, HSBC's Sharing Percentage within thirty (30) days after the earliest to occur of the Credit being claimed on a return or amended return, the Credit being approved/granted by the state, or the allowance of an audit offset by the state. In the event Merchant fails to pay the Sharing Percentage to HSBC within such thirty (30) day period, Merchant shall also pay interest to HSBC on its Sharing Percentage at the rate of 1% per month until paid.

**IX. Audit Assessment.** In the event either party is audited or assessed by a governmental entity and, as a result of such assessment any Refund or Credit resulting from a Mutual Claim is required to be returned to the governmental entity, the non-audited party will pay the audited party its Sharing Percentage of the Refund or Credit returned by the audited party, plus its Sharing Percentage of any interest and/or penalties paid by the audited party (except interest and penalties caused solely by the audited party's acts, omissions, or negligence), within thirty (30) days after the audited party pays such amount to the State and provides written proof of payment to the non-audited party. In the event a non-audited party fails to pay the amounts described in the immediately preceding sentence to the audited party within such thirty (30) day period, the non-audited party shall also pay to the audited party interest on such amount at the rate of 1% per month until paid.



**X. Chargebacks and Repurchases.** Merchant agrees that HSBC or Merchant may file Refunds or claim Credits with respect to sales tax, gross receipts tax, transaction privilege tax, or other similar tax imposed on sales of tangible property with respect to any Accounts in states (and local jurisdictions) in which HSBC and Merchant mutually agree, that were originated with customers of Merchant who financed their retail purchases through HSBC and which HSBC charged back to Merchant pursuant to Article 6 of this Agreement (“Chargeback Mutual Claims”). Merchant and HSBC agree that the terms outlined above in Sections III through VIII of this Schedule 2.10 shall apply to Chargeback Mutual Claims except that the Sharing Percentage for the Chargeback Mutual Claims is seventy-five percent (75%) for the Merchant and twenty-five (25%) for HSBC . HSBC may elect to not participate for a particular period or in a particular state. In the event HSBC elects to not participate for a particular period or in a particular state, Merchant may elect to pursue such Refund or Credit for its own account for such period or state and Merchant shall be entitled to all proceeds received from such Refund or Credit. In the event of a termination of this Agreement, all Chargeback Mutual Claims filed or pending prior to such termination shall continue to be processed and governed by the terms of this Schedule 2.10 (a Chargeback Mutual Claim is pending with respect to an Account if the Account has been charged off by HSBC prior to or after the termination of this Agreement, but no Chargeback Mutual Claim has been filed as of the date of termination of this Agreement with respect to such Account).

**CERTIFICATION**

I, Edward J. Bramson, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Nautilus, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

November 10, 2008

Date

By: /s/ Edward J. Bramson

Edward J. Bramson,  
Chairman and Chief Executive Officer  
(Principal Executive Officer)

**CERTIFICATION**

I, William D. Meadowcroft, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Nautilus, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

November 10, 2008

Date

By: /s/ William D. Meadowcroft

William D. Meadowcroft,

Chief Financial Officer (Principal Financial Officer)

**EXHIBIT 32.1**

**Certification**

**Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  
(Subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code)**

Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code), the undersigned officer of Nautilus, Inc., a Washington corporation (the “Company”), does hereby certify that:

To my knowledge, the Quarterly Report on Form 10-Q for the period ended September 30, 2008 (the “Form 10-Q”) of the Company fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and information contained in the Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of the Company.

November 10, 2008

Date

By: /s/ Edward J. Bramson

Edward J. Bramson,  
Chairman and Chief Executive Officer  
(Principal Executive Officer)

To my knowledge, the Quarterly Report on Form 10-Q for the period ended September 30, 2008 (the “Form 10-Q”) of the Company fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and information contained in the Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of the Company.

November 10, 2008

Date

By: /s/ William D. Meadowcroft

William D. Meadowcroft  
Chief Financial Officer (Principal Financial Officer)