

North Atlantic Holding Company, Inc.  
Form 10-Q  
August 14, 2006

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20459

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**FORM 10-Q**

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

For the quarterly period ended June 30, 2006

or

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

For the transaction period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 333-115587

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**NORTH ATLANTIC HOLDING COMPANY, INC.**

(Exact Name of Registrant as Specified in Its Charter)

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**DELAWARE**  
(State or Other Jurisdiction of  
Incorporation or Organization)

**20-0709285**  
(I.R.S. Employer  
Identification No.)

**3029 West Muhammad Ali Boulevard, Louisville, KY**  
(Address of Principal Executive Offices)

**40212**  
(Zip Code)

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(502) 778-4421

(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. (Check One).

Large accelerated filer  Accelerated filer  Non-accelerated filer .

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 664,741 shares of common stock, \$.01 par value, as of August 11, 2006.

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## PART I

## FINANCIAL INFORMATION

## Item 1. Financial Statements

**North Atlantic Holding Company, Inc. and Subsidiaries****Condensed Consolidated Balance Sheets**

(dollars in thousands except per share data)

(unaudited)

	June 30, 2006	December 31, 2005
<b>Current assets:</b>		
Cash	\$ 1,326	\$ 525
Accounts receivable, net	5,202	6,718
Inventories	32,547	30,572
Other current assets	3,880	5,166
<b>Total current assets</b>	<b>42,955</b>	<b>42,981</b>
Property, plant and equipment, net	13,995	14,382
Deferred financing costs, net	9,886	10,810
Goodwill	128,697	128,697
Other intangible assets, net	9,632	9,852
Other assets	19,969	19,062
<b>Total assets</b>	<b>\$ 225,134</b>	<b>\$ 225,784</b>
<b>Current liabilities:</b>		
Accounts payable	\$ 2,095	\$ 6,272
Accrued expenses	5,912	7,130
Accrued interest expense	6,167	6,167
Deferred income taxes	3,754	3,928
Revolving credit facility	4,000	
<b>Total current liabilities</b>	<b>21,928</b>	<b>23,497</b>
Notes payable and long-term debt	265,226	263,195
Deferred income taxes	6,682	6,106
Postretirement benefits	7,115	6,762
Pension benefits and other long-term liabilities	3,019	3,166
<b>Total liabilities</b>	<b>303,970</b>	<b>302,726</b>
<b>Stockholder's Equity:</b>		
Common stock, voting, \$.01 par value; June 30, 2006; authorized shares, 1,000,000; issued shares 666,908, outstanding shares, 664,741, shares held in treasury, 2,167; \$.01 par value; 2005; authorized shares, 1,000,000; issued shares 588,758, outstanding shares, 586,591, shares held in treasury, 2,167	7	6
Common stock, non-voting, \$.01 par value; authorized shares, 750,000; issued and outstanding shares, 0		
Additional paid-in capital	5,232	5,236
Loans to stockholders for stock purchase	(96)	(99)
Accumulated other comprehensive income (loss)	(1,171)	(1,830)
Accumulated deficit	(82,808)	(80,255)

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Total stockholders' equity (deficit)	(78,836)	(76,942)
Total liabilities and stockholders' deficit	\$ 225,134	\$ 225,784

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

**North Atlantic Holding Company, Inc. and Subsidiaries****Condensed Consolidated Statements of Operations**

(dollars in thousands except per share amounts)

(unaudited)

	Three months Ended June 30, 2006	Three months Ended June 30, 2005
Net sales	\$ 29,126	\$ 30,521
Cost of sales	12,899	15,108
Gross profit	16,227	15,413
Selling, general and administrative expenses	10,082	13,395
Amortization expense	109	110
Operating income (loss)	6,036	1,908
Interest expense and financing costs, net	6,594	7,707
Income (loss) before income tax expense (benefit)	(558)	(5,799)
Income tax expense (benefit)	201	(198)
Net income (loss)	\$ (759)	\$ (5,601)
Basic and Diluted earnings per common share:		
Net income (loss)	\$ (1.24)	\$ (9.50)
Weighted average common shares outstanding:		
Basic	613,214	589,403
Diluted	613,214	589,403

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

**North Atlantic Holding Company, Inc. and Subsidiaries**

**Condensed Consolidated Statements of Operations**

(dollars in thousands except per share amounts)

(unaudited)

	Six months Ended June 30, 2006	Six months Ended June 30, 2005
Net sales	\$ 57,550	\$ 57,869
Cost of sales	25,973	28,262
Gross profit	31,577	29,607
Selling, general and administrative expenses	20,149	26,496
Amortization expense	220	221
Operating income (loss)	11,208	2,890
Interest expense and financing costs, net	13,359	15,147
Income (loss) before income tax expense (benefit)	(2,151)	(12,257)
Income tax expense (benefit)	402	3
Net income (loss)	\$ (2,553)	\$ (12,260)
Basic and Diluted earnings per common share:		
Net income (loss)	\$ (4.26)	\$ (20.80)
Weighted average common shares outstanding:		
Basic	599,976	589,403
Diluted	599,976	589,403

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

**North Atlantic Holding Company, Inc. and Subsidiaries****Condensed Consolidated Statements of Cash Flows**

(dollars in thousands)

(unaudited)

	Six months Ended June 30, 2006	Six months Ended June 30, 2005
Cash flows from operating activities:		
Net income (loss)	\$ (2,553)	\$ (12,260)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation expense	1,022	436
Amortization expense	220	220
Amortization of deferred financing costs	923	1,329
Amortization of interest on senior discount notes	2,032	4,035
Deferred income taxes	402	3
Stock compensation expense	(5)	60
Changes in operating assets and liabilities:		
Accounts receivable, net	1,516	(232)
Inventories	(1,316)	2,790
Other current assets	1,286	730
Other assets	(907)	(1,337)
Accounts payable	(4,177)	(2,559)
Accrued expenses and other	(1,218)	2,179
Accrued pension liabilities	(147)	148
Accrued postretirement liabilities	353	12
Net cash provided by (used in) operating activities	(2,569)	(4,446)
Cash flows from investing activities:		
Capital expenditures	(635)	(1,300)
Net cash provided by (used in) investing activities	(635)	(1,300)
Cash flows from financing activities:		
Proceeds from term loan		30,000
Proceeds (payments) from (to) revolving credit facility, net	4,000	(14,500)
Payment of financing costs		(1,808)
Other	5	3
Net cash provided by (used in) financing activities	4,005	13,695
Net increase (decrease) in cash	801	7,949
Cash, beginning of period	525	2,347
Cash, end of period	\$ 1,326	\$ 10,296

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





**North Atlantic Holding Company, Inc. and Subsidiaries**

**Condensed Consolidated Statements of Comprehensive Income (Loss)**

(dollars in thousands)

(unaudited)

	<b>Three months</b>	<b>Three months</b>
	<b>Ended</b>	<b>Ended</b>
	<b>June 30,</b>	<b>June 30,</b>
	<b>2006</b>	<b>2005</b>
Net income (loss)	\$ (759)	\$ (5,601)
Other comprehensive income, net of tax benefit:		
Unrealized gains on derivative financial instruments:		
Unrealized gains arising during period	\$ 196	
Plus: adjustment for losses included in net income	169	365
Comprehensive income (loss)	\$ (394)	\$ (5,601)

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

**North Atlantic Holding Company, Inc. and Subsidiaries**

**Condensed Consolidated Statements of Comprehensive Income (Loss)**

(dollars in thousands)

(unaudited)

	Six months Ended June 30, 2006	Six months Ended June 30, 2005
Net income (loss)	\$ (2,553)	\$ (12,260)
Other comprehensive income, net of tax benefit:		
Unrealized gains on derivative financial instruments:		
Unrealized gains arising during period	\$ 517	
Plus: adjustment for losses included in net income	142	659
Comprehensive income (loss)	\$ (1,894)	\$ (12,260)

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

North Atlantic Holding Company, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(dollars in thousands, except where designated and per share data)

(unaudited)

## 1. Organization

These condensed consolidated financial statements should be read in conjunction with the financial statements and related notes thereto included in North Atlantic Holding Company, Inc.'s (the Company) Annual Report on Form 10-K for the year ended December 31, 2005.

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

## 2. Summary of Significant Accounting Policies

**Revenue Recognition:** The Company recognizes revenues and the related costs upon delivery to the customer, at which time there is a transfer of title and risk of loss to the customer in accordance with Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements, as amended by Staff Accounting Bulletin No. 104, Revenue Recognition. The Company classifies customer rebates as sales deductions in accordance with the requirements of Emerging Issues Task Force Issue No. 01-09.

**Shipping Costs:** The Company records shipping costs incurred as a component of selling, general and administrative expenses. Shipping costs incurred were \$1.3 million and \$1.1 million for the three months ended June 30, 2006 and 2005, respectively, and \$2.4 million and \$2.3 million for the six months ended June 30, 2006 and 2005, respectively.

**Financial Instruments:** The Company enters into foreign currency forward contracts to hedge a portion of its exposure to changes in foreign currency exchange rates on inventory purchase commitments. The Company accounts for its forward contracts under the provisions of Statement of Financial Accounting Standards No. 133 (SFAS 133), Accounting for Derivative Instruments and Hedging Activities. The Company may hedge up to eighty percent of its anticipated purchases of inventory under the Bolloré, S.A. master contract, denominated in Euros, over a forward period not to exceed twelve months. The Company may also, from time to time, hedge up to ninety percent of its non-inventory purchases in the denominated invoice currency. Forward contracts that qualify as hedges are adjusted to their fair value through other comprehensive income as determined by market prices on the measurement date. As of June 30, 2006, the adjustment to record the increase in fair value relating to the forward contracts amounted to approximately \$582 and is recorded as an asset and other comprehensive income. Gains and losses on these

contracts are transferred from other comprehensive income into net income as the related inventories are received. Changes in fair value of any contracts that do not qualify for hedge accounting or are not designated as hedges are recognized in income currently.

**Master Settlement Agreement Escrow Account:** Pursuant to the Master Settlement Agreement (the MSA) entered into in November 1998 by most states (represented by their attorneys general acting through the National Association of Attorneys General) and subsequent states' statutes, a cigarette manufacturer (which is defined to include a manufacturer of make-your-own cigarette tobacco) has the option of either becoming a signatory to the MSA or opening, funding, and maintaining an escrow account to have funds available for certain potential tobacco-related liabilities, with sub-accounts on behalf of each settling state. The Company has chosen to open and fund an escrow account as its method of compliance. It is the Company's policy to record amounts on deposit in the escrow account for prior years, as well as cash-on-hand to fund its projected deposit based on its monthly sales for the current year, as an Other non-current asset. Each year's obligation is required to be deposited in the escrow account by April 15 of the following year. During April 2006, approximately \$3.3 million relating to 2005 sales was deposited. As of June 30, 2006 and December 31, 2005, the Company has recorded approximately \$20.0 million and \$17.6 million, respectively, in Other assets.

**Revision:** During 2006, the Company revised the 2005 cash flow statement for the classification of stock compensation expense from financing activities to operating activities. This revision did not have a material effect on the statement.

### 3. Inventories

Inventories are stated at the lower of cost or market. Cost is determined on the last-in, first-out (LIFO) method for approximately 97% of the inventories. Leaf tobacco is presented in current assets in accordance with standard industry practice, notwithstanding the fact that such tobaccos are carried longer than one year for the purpose of curing.

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

	6/30/06	12/31/05
Raw materials and work in process	\$ 3,019	\$ 3,242
Leaf tobacco	4,598	5,948
Finished goods - loose leaf tobacco	3,345	2,275
Finished goods - MYO products	9,699	6,522
Other	1,345	1,594
	22,006	19,581
LIFO reserve	10,541	10,991
	\$ 32,547	\$ 30,572

### 4. New Senior Notes

On February 9, 2004, North Atlantic Trading Company, Inc., a Delaware corporation (NATC), consummated its general corporate reorganization in which the Company was created and became the parent company of NATC. On February 17, 2004, NATC consummated the refinancing of its existing debt and preferred stock and the Company

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

The Senior Discount Notes and New Senior Notes are as follows:

	6/30/06	12/31/05
Senior Discount Notes	\$ 35,226	\$ 33,195
New Senior Notes	200,000	200,000
Term loan	30,000	30,000
	\$ 265,226	\$ 263,195

During the fourth quarter of 2005, NATC purchased Senior Discount Notes of the Company with an accreted book value of approximately \$41.0 million (face value at maturity of approximately \$54.1 million) for approximately \$12.7 million in cash. The Company or NATC may, from time to time, continue to acquire and/or retire all or a portion of the Senior Discount Notes and/or New Senior Notes through cash purchases and/or exchanges for other securities in open market purchases, privately negotiated transactions or otherwise.

The Company is dependent on NATC's cash flows to service its debt. The amount of cash interest to be paid by the Company during the next five years is as follows: \$0 in each of 2006, 2007 and March 1, 2008; approximately \$2,628 payable on September 1, 2008 and approximately \$2,628 payable on each of March 1 and September 1 thereafter until maturity.

## 5. Financing Agreement

On June 16, 2005, NATC refinanced the 2004 Credit Agreement by entering into a Financing Agreement (the Financing Agreement ) with various financial institutions ( Lenders ) and Fortress Credit Corp., as agent for the Lenders ( Agent ). The Financing Agreement consists of a \$30.0 million term loan facility and a \$55.0 million revolving credit facility, and includes a letter of credit sublimit of \$10.0 million (collectively, the Credit Facility ). As of June 30, 2006, NATC had an outstanding balance on the revolving credit facility of \$4.0 million. The Credit Facility, including the term loan, will mature on June 30, 2010, and does not provide for any amortization of the term loan prior to maturity. NATC will use the revolving credit facility for working capital requirements and other general corporate purposes. Indebtedness under the Financing Agreement is guaranteed by the Company and each of NATC's current and future subsidiaries, and is secured by a first perfected lien on substantially all of the Company's and its direct and indirect subsidiaries' current and future assets and property. The collateral includes a pledge by the Company of its equity interest in NATC and a first priority lien on all equity interests and intercompany notes held by NATC and its direct and indirect subsidiaries.

Loans and advances under the Financing Agreement bear interest at a variable rate based on either the prime rate or LIBOR, at the Company's option, plus a specified margin ranging from 1.00% to 3.75% in case of prime rate indebtedness, and from 3.50% to 6.25% in the case of LIBOR indebtedness, based on the sum of NATC's secured indebtedness in relation to its EBITDAR, as defined in the Financing Agreement. As of June 30, 2006, the interest rate on the Company's term loan was 8.625%.

NATC paid the Lenders a closing fee of \$1.275 million and is required to pay the Agent a quarterly servicing fee in the amount of \$25. Under the revolving credit facility, NATC is required to pay the Lenders an annual commitment fee in an amount equal to 0.50% of the difference between \$40.0 million and the average usage of the revolving credit facility, payable on a monthly basis. NATC is also required to pay the Lenders letter of credit fees equal to 4.00% per annum multiplied by the face amount of the letters of credit issued under the Financing Agreement, payable on the date any such letter of credit is issued. In addition, NATC is required to pay the Agent the standard charges customarily charged by the institution issuing letters of credit under the Financing Agreement in connection with the issuance, administration, amendment, payment or cancellation of any such letters of credit.

The Financing Agreement requires NATC to meet a maximum leverage ratio and a test of minimum earnings before interest, taxes, depreciation, amortization, certain cash and non-cash charges, other income and expenses and restructuring charges (EBITDAR). The Financing Agreement also contains covenants which, among other things, limit the incurrence of additional indebtedness, distribution of dividends, transactions with affiliates, asset sales, acquisitions, mergers, prepayments of other indebtedness, liens and encumbrances, capital expenditures, and other matters customarily restricted in such agreements. In addition, the Financing Agreement requires that the Chief Executive Officer of NATC be reasonably acceptable to the Agent and the Lenders during the term of the Credit Facility. At June 30, 2006, NATC was in compliance with all provisions of the Financing Agreement.

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

NATC's Credit Facility will require a \$30.0 million payment on the term loan on June 30, 2010.

## **6. Provision for Income Taxes**

The Company has determined that at June 30, 2006, its ability to realize future benefits of certain net deferred tax assets does not meet the "more likely than not" criteria in SFAS No. 109, "Accounting for Income Taxes"; therefore, a valuation allowance continues to be recorded. Deferred income tax liabilities are provided relating to inventories and tax-deductible goodwill that is not amortized for financial reporting.

**7. Pension and Postretirement Benefit Plans**

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

	Pension Benefits		Postretirement Benefits	
	2006	2005	2006	2005
Service cost	\$ 22	\$ 22	\$ 178	\$ 80
Interest cost	395	389	259	74
Expected return of plan assets	(468)	(313)		
Amortization of net (gain) loss	66	50	70	27
<b>Net periodic pension cost</b>	<b>\$ 15</b>	<b>\$ 148</b>	<b>\$ 507</b>	<b>\$ 181</b>

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

NATC froze the defined benefit retirement plan for the respective hourly employees of its three collective bargaining units and terminated its postretirement benefit plan for its salaried employees in 2004. NATC expects to contribute approximately \$300 to its postretirement plan in 2006 for the payment of benefits. Plan contributions and benefits have amounted to \$154 for the six months ended June 30, 2006. Based upon the above decision, management believes that any future contributions will not be material.

**8. Share Incentive Plans**

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123R, Share-Based Payment ( SFAS No. 123R ), using the modified prospective transition method. Under the method, stock-based compensation expense will continue to be recognized using the fair-value based method for all awards granted. Compensation expense for unvested stock options and awards that were outstanding on December 31, 2005 will continue to be recognized over the requisite service period based on the grant-date fair value of those options and awards as previously calculated under SFAS No. 123. The Company determined the fair value of these awards using the Black-Scholes option pricing model.

The Company has three share incentive plans covering certain key employees of NATC which provide for the granting of options to purchase common stock of the Company and other stock related benefits. The North Atlantic Trading Company Inc. 1997 Share Incentive Plan (the 1997 Plan ), now relating to the Company's common stock, made available 61,856 shares (all of which have been granted) to key employees of NATC based on the discretion of a committee appointed by the Board of Directors (the Administration Committee ). The 1997 Plan provides for the grant of any or all of the following types of

benefits: (1) stock options, including incentive stock options and non-qualified stock options; (2) stock appreciation rights; (3) stock awards, including restricted stock; (4) performance awards; and (5) stock units. The Administration Committee shall determine the treatment to be afforded to a participant in the event of termination of employment for any reason including death, disability, or retirement. The 1997 Plan contains provisions for equitable adjustment of benefits in the event of a merger, consolidation, reorganization, recapitalization, stock dividend, stock split, reverse stock split, split up, spin-off, combination of shares, exchange of shares, dividend in kind or other like change in capital structure or distribution (other than normal cash dividends) to stockholders of the Company.

In November 2002, the Board of Directors of the Company adopted the North Atlantic Trading Company, Inc. 2002 Share Incentive Plan (the 2002 Plan ), now relating to the Company s common stock. The 2002 Plan has terms that are substantially identical to the terms of the 1997 Plan. The Company has reserved 50,000 shares of common stock (all of which have been granted) for benefits under the 2002 Plan. The 1997 Plan and the 2002 Plan contain a four year vesting period and expire ten years from the respective date of the plans. The Board of Directors of the Company reserves the right to amend, suspend or terminate the 1997 Plan and 2002 Plan at any time, subject to the rights of participants with respect to any outstanding benefits.

On February 8, 2006, the Board of Directors of the Company adopted the North Atlantic Holding Company, Inc. 2006 Equity Incentive Plan (the 2006 Plan ) and approved a form of Restricted Stock Award Agreement (the Form Award Agreement ) pursuant to which awards under the 2006 Plan may be granted to employees. The Form Award Agreement requires, as a condition of the award, that any and all stock options (vested or otherwise) previously granted to these individuals will be immediately cancelled as of the date of the award. On March 15, 2006, the Board of Directors of the Company approved a form of Restricted Stock Award Agreement pursuant to which awards under the 2006 Plan may be granted to non-employee directors (the Director Form Award Agreement ). The 2006 Plan provides for the granting of nonqualified stock options and restricted stock awards. Pursuant to the 2006 Plan, 175,503 shares of common stock of the Company are reserved for issuance as awards to employees, consultants and directors as compensation for past or future services or the attainment of certain performance goals. The Board of Directors of the Company may provide that awards under the 2006 Plan shall become vested in installments over a period of time or may specify that the attainment of certain performance measures will determine the degree of vesting, or a combination of both, as set forth in the applicable award agreements. Upon the occurrence of a change in control, the grantee shall be entitled to such consideration in respect of the outstanding shares subject to the 2006 Plan on the same terms and conditions as that provided to all other stockholders of the Company. The 2006 Plan is scheduled to terminate on February 17, 2016, the day before the tenth anniversary of its adoption by the Board. As of June 30, 2006, 78,150 shares of restricted stock have been granted to employees of the Company under the 2006 Plan.



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The total number of shares available for grant under the 1997 Plan, 2002 Plan and 2006 Plan is 0, 0 and 97,353, respectively. Stock option activity is summarized below:

	Incentive Shares	Weighted Average Exercise Price	Weighted Average Grant Date Fair Value
Outstanding, December 31, 2004	\$ 106,356	\$ 32.33	\$ 32.75
Granted			
Exercised			
Forfeited	(8,741)	(62.00)	(20.25)
Outstanding, December 31, 2005	97,615	29.67	33.87
Granted			
Exercised			
Forfeited	(14,822)	(62.00)	(22.75)
Outstanding, June 30, 2006	82,793	\$ 21.89	\$ 35.86

The total intrinsic value of options exercised and vested during the six months ended June 30, 2006 and June 30, 2005 was \$0 and \$0, respectively.

At June 30, 2006, under the 1997 and 2002 plans, the outstanding stock options exercise price for 61,856 options is \$9.99 per share, all of which are exercisable. The outstanding stock options exercise price for 20,937 options is \$62.00, 15,870 of which are exercisable with the remaining 5,067 becoming vested from 2006 through 2008. The weighted average of the remaining lives of the outstanding stock options is approximately 6.0 years for the options with the \$9.99 exercise price and 5.8 years for the options with the \$62.00 exercise price. The Company estimates that the expected life of all stock options is five years from the date of grant. The weighted average fair value of the options was determined as the difference between the fair value of the common stock on the grant date and the present value of the exercise price over the expected life of five years at a risk free interest rate of 6%, with no assumed dividend yield.

Of the stock options described above, 82,793 include a provision under which the Company will reimburse the employee for the difference between his or her ordinary income tax liability and the liability computed using the capital gains rate in effect upon exercise of the options. The effect of this provision is accounted for as a variable portion of the option plan.

The Company has recorded compensation expense related to the options based on the provisions of SFAS No. 123R under which the fixed portion of such expense is determined as the fair value of the options on the date of grant and amortized over the vesting period. The variable portion of the compensation expense is measured on each reporting date with the expense amount adjusted for changes in the fair value of the Company's stock on that date. The Company recorded compensation expense of approximately (\$5) and \$60 in the Statements of Operations for the six months ended June 30, 2006 and 2005, respectively. Included within the 2006 compensation expense is \$45 relating to forfeitures. The total compensation expense related to non-vested awards is expected to be approximately \$78 which will be recognized over the next two years.

**9. Reconciliation of Income (Loss) per Common Share**

(dollars and shares in thousands, except per share amounts)

**Three Months Ended June 30, 2006**

	Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic and Diluted:			
Net income (loss)	\$ (759)		
Net income (loss)	\$ (759)	613,214	\$ (1.24)

**Three Months Ended June 30, 2005**

	Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic and Diluted:			
Net income (loss)	\$ (5,601)		
Net income (loss)	\$ (5,601)	589,403	\$ (9.50)

**Six Months Ended June 30, 2006**

	Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic and Diluted:			
Net income (loss)	\$ (2,553)		
Net income (loss)	\$ (2,553)	599,976	\$ (4.26)

**Six Months Ended June 30, 2005**

	Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic and Diluted:			
Net income (loss)	\$ (12,260)		
Net income (loss)	\$ (12,260)	589,403	\$ (20.80)

**10. Recently Issued Accounting Pronouncements**

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs - an amendment of ARB No. 43, Chapter 4*, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). SFAS No. 151 requires that items be recognized as current-period charges regardless of whether they meet the criterion of "so abnormal" that was previously stated in ARB No. 43, Chapter 4. In addition, SFAS No. 151 requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. The provisions of this statement shall be effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of SFAS No. 151 did not have a material impact on the Company's financial condition or results of operations.



In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets - an amendment of APB Opinion No. 29, to eliminate the exception for nonmonetary exchanges of similar productive assets and replace it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. The guidance is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of SFAS No. 153 did not have a material impact on the Company's financial condition or results of operations.

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

#### **11. Reclassification**

The Company has changed the criteria for items to be included in Selling, general and administrative expenses to conform to prevailing industry practices. The Company has restated its prior period Statement of Operations to reflect the new classification criteria. This resulted in the reclassification of \$0.8 million and \$1.6 million from Other income/(expense), which includes, but is not limited to, litigation expenses, reversals and recoveries, to Selling, general and administrative expenses for the three months and six months ended June 30, 2005, respectively.

#### **12. Contingencies**

##### **Litigation with Republic Tobacco**

On July 15, 1998, North Atlantic Operating Company, Inc. ( NAOC ) and National Tobacco Company, L.P. ( NTC ), which are subsidiaries of the Company, filed a complaint (the Kentucky Complaint ) against Republic Tobacco, Inc. and its affiliates ( Republic Tobacco ) in Federal District Court for the Western District of Kentucky. Republic Tobacco imports and sells Roll-Your-Own ( RYO ) premium cigarette papers under the brand names JOB and TOP as well as other brand names. The Kentucky Complaint alleges, inter alia, that Republic Tobacco's use of exclusivity agreements, rebates, incentive programs, buy-backs and other activities related to the sale of premium cigarette papers in the southeastern United States violate federal and state antitrust and unfair competition laws.

and that Republic Tobacco defaced and directed others to deface NAOC's point of purchase vendor displays for premium cigarette papers by covering up the **ZIG-ZAG** brand name and advertising material with advertisements for Republic Tobacco's RYO cigarette paper brands. The Kentucky Complaint alleges that these activities constitute unfair competition under federal and state laws.

On June 30, 1998, Republic Tobacco filed a complaint against NATC, NAOC and NTC in the U.S. District Court of the Northern District of Illinois (the Illinois Complaint) and served it on the Company after the institution of the Kentucky action. In the Illinois Complaint, Republic Tobacco seeks declaratory relief with respect to NATC's claims. In addition, the Illinois Complaint alleges that certain actions taken by NATC to inform its customers of its claims against Republic Tobacco constitute tortious interference with customer relationships, false advertising, violations of Uniform Deceptive Trade Practices and Consumer Fraud Acts, defamation and unfair competition. In addition, although not included in its original complaint but in its amended complaint, Republic Tobacco alleged that NATC has unlawfully monopolized and attempted to monopolize the market on a national and regional basis for premium cigarette papers. Republic sought unspecified compensatory damages, injunctive relief and attorneys fees and costs.

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

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

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

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

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

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

On August 3, 2005, the District Court issued its ruling and awarded NATC approximately \$1.1 million. This amount is not included in the condensed consolidated financial statements. On August 11, 2005, Republic Tobacco filed a notice of appeal. Such appeal is currently being briefed. Republic Tobacco filed its opening brief on July 18, 2006. NATC's response brief is due on August 22, 2006. Republic Tobacco's reply brief is due on September 7, 2006. No oral argument has yet been scheduled on Republic Tobacco's appeal.

On February 21, 2006, Top Tobacco, LP, an affiliate of Republic Tobacco, filed a complaint against North Atlantic Operating Company, Inc., a subsidiary of the Company, in Federal District Court for the Northern District of Illinois, alleging that the Company's use of the phrase "Fresh-Top Canister" on the side of its ZIG-ZAG CLASSIC AMERICAN BLEND cigarette tobacco infringes, damages and violates Top Tobacco's TOP trademark for tobacco. Top Tobacco requests injunctive relief, and unquantified royalties and damages. The Company intends to vigorously defend the claim and believes that it has strong defenses to the claims. However, no assurances can be given that the Company will prevail, and if the Company were to lose, there could be a material adverse effect.

On May 16, 2006, Republic Tobacco L.P. ( Republic ) filed a complaint against North Atlantic Trading Company, Inc., North Atlantic Operating Company, Inc., and National Tobacco Company, L.P., in Federal District Court for the Northern District of Illinois, alleging that the defendants made oral and written presentations to Republic's customers that defamed Republic's president by implying he was not truthful in prior court testimony and wrongfully disparaged Republic's JOB cigarette paper products. Republic alleges the defendants' conduct constituted false advertising in violation of the Lanham Act (Count I), represented a deceptive trade practice in violation of the Illinois Uniform Deceptive Trade

Practices Act (Count II), violated the Illinois Consumer Fraud Act (Count III), constituted common law defamation, trade liable and commercial disparagement (Count IV), and, finally constituted unfair competition under common law (Count V). On June 30, 2006, the defendants answered the complaint, denying all of the alleged violations. The defendants also counterclaimed against Republic for false advertising in the marketing of cigarette paper products in violation of the Lanham Act (Counterclaim Count I), for tortuous interference with the defendants' customers (Counterclaim Count II) and for deceptive trade practices in Republic's marketing of cigarette paper products, in violation of Illinois law (Counterclaim Count III). On July 7, 2006, the defendants moved to dismiss Count III and V of Republic's complaint for failure to state a claim as a matter of law. The parties are currently briefing that motion to dismiss. The court has ordered that fact and expert discovery in the case shall be completed by October 27, 2006, and any motions for summary judgment are to be filed by November 29, 2006, with briefing on such motions completed by December 20, 2006. The Company intends to vigorously defend these claims and believes that it has strong defenses to the claims. The Company also intends to vigorously prosecute its counterclaims. However, no assurances can be given that the Company will prevail, and if the Company were to lose, there could be a material adverse effect.

#### **Litigation Related to Counterfeiting**

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

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

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

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

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

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

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

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



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

#### **Litigation Related to Alleged Personal Injury**

West Virginia Complaints. Trial of the West Virginia complaints against the smokeless tobacco defendants has been postponed indefinitely, as described below. On October 6, 1998, NTC was served with a summons and complaint on behalf of 65 individual plaintiffs in an action in the Circuit Court of Kanawha County, West Virginia, entitled Kelly Allen, et al. v. Philip Morris Incorporated, et al. (Civil Action Nos. 98-C-2401). On November 13, 1998, NTC was served with a second summons and complaint on behalf of 18 plaintiffs in an action in the Circuit Court of Kanawha County, West Virginia, entitled Billie J. Akers, et al. v. Philip Morris Incorporated et al. (Civil Action Nos. 98-C-2696 to 98-C-2713). The complaints are identical in most material respects. In the Allen case, the plaintiffs have specified the defendant companies for each of the 65 cases. NTC is named in only one action. One Akers plaintiff alleged use of an NTC product, alleging lung cancer.

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

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

In November 2001, NTC was served with an additional four separate summonses and complaints in actions filed in the Circuit Court of Ohio County, West Virginia. The actions are entitled Donald Nice v. Philip Morris Incorporated, et al. (Civil Action No. 01-C-479), Korene S. Lantz v. Philip Morris Incorporated, et al. (Civil Action No. 01-C-480), Ralph A. Prochaska, et al. v. Philip Morris, Inc., et al. (Civil Action No. 01-C-481), and Franklin Scott, et al. v. Philip Morris, Inc., et al. (Civil Action No. 01-C-482). On August 19, 2004, the Korene Lantz lawsuit was voluntarily dismissed by the plaintiff against all defendants including NTC. The Donald Nice lawsuit was dismissed on July 18, 2005 against all defendants including NTC for failure of the plaintiff to follow the case management order.

All of the West Virginia smokeless tobacco actions have been consolidated before the West Virginia Mass Litigation Panel for discovery and trial of certain issues. Trial of these matters was planned in two phases. In the initial phase, a trial was to be held to determine whether tobacco products, including all forms of smokeless tobacco, cigarettes, cigars and pipe and roll-your-own tobacco, can cause certain specified diseases or conditions. In the second phase, individual plaintiffs would attempt to prove that they were in fact injured by tobacco products. Fact and expert discovery in these cases has closed; however, in the cigarette cases the Court has allowed additional discovery.

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

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

By opinion dated December 2, 2005, the Supreme Court of Appeals of West Virginia completed its review of a certified question arising from the trial court's initial trial plan that had been established to resolve claims against the cigarette manufacturer defendants. The Supreme Court of West Virginia determined that the United States Supreme Court's decision in *State Farm Mutual Automobile Insurance Company v. Campbell*, 538 U.S. 408 (2003), did not preclude a trial plan in which phase I of the plan would decide certain elements of liability and a punitive damages multiplier and Phase II would decide each plaintiff's entitlement to compensatory damages and punitive damages based upon the multiplier determined in Phase I. The action has been remanded to the circuit court to fashion a new trial plan for the consolidated cases. On April 28, 2006, the trial court entered an order reinstating the original trial plan, and set a trial date of March 19, 2007 for the trial of issues against the cigarette defendants only. The claims against the smokeless tobacco manufacturer defendants remain severed and indefinitely stayed. While the Company intends to defend these cases vigorously should they ever go to trial, and believes it has strong defenses, no assurance can be given the Company would prevail. If the Company were not to prevail, the result could be a material adverse event.

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

#### **Other Employment Matters**

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

David I. Brunson, the former President, Chief Financial Officer and Treasurer of the Company, resigned from the Company effective January 19, 2005, at which time his employment agreement with the Company (the "Brunson Employment Agreement") was effectively terminated. Pursuant to the Brunson Employment Agreement, the Company is required to make certain severance payments to Mr. Brunson, including \$425, which was paid within ten business days after January 19, 2005, and an additional \$425, which was paid in bi-weekly installments from January 20, 2005 through January 19, 2006. In addition, Mr. Brunson may become entitled to a bonus payment of up to \$725 relating to synergies achieved in the integration of the business of Stoker, Inc., which was acquired by the Company in 2003. Pursuant to the Brunson Employment Agreement, after the last severance payment is made, Mr. Brunson will have an option to require the Company to repurchase all or a portion of his shares of the Company at their fair market value. The Company will not be obligated to repurchase these shares if, upon or after the payment, it would be in default under any instrument, agreement or law by which it is bound; in this case, the repurchase may be deferred until it can be completed without such default. Similarly, the Company has an option to repurchase Mr. Brunson's shares at their fair market value. In the event the Company and Mr. Brunson are unable to agree upon the fair market value of these shares, an independent investment banking firm will be selected to determine such fair market value, in accordance with the procedure provided for by the Brunson Employment Agreement. If neither Mr. Brunson nor the Company exercise their respective options by the earliest of the fifth anniversary of the termination of Mr. Brunson's employment or the date on which the Company refinances, or uses proceeds derived from refinancing, certain of its obligations, the Company will be required to repurchase Mr. Brunson's shares on such date unless Mr. Brunson waives his right to require the Company to purchase his shares. Any liability is deemed, at this time, not to be material to the Company's Condensed Consolidated Financial Statements. No amounts have been accrued related to potential amounts payable to Mr. Brunson associated with the Stoker restructuring bonus or the requirement to repurchase his stock. On January 23, 2006, Mr. Brunson filed a verified complaint against the Company in the Supreme Court of New York, County of Westchester, alleging breach of his employment agreement and related claims arising out of his resignation from employment with the Company. Mr. Brunson claims that he is entitled to \$1.5 million in unpaid severance pay and at least \$1.2 million in unpaid incentive bonus compensation under his employment agreement. Alternatively, Mr. Brunson seeks payment of the alleged unpaid incentive bonus compensation under differing, but related theories of recovery. Mr. Brunson also seeks payment of his attorneys' fees. The Company vigorously disputes Mr. Brunson's allegations and responded to Mr. Brunson's complaint on March 31, 2006 by filing a motion to dismiss four of seven claims contained in Mr. Brunson's complaint on the grounds that they were duplicative or otherwise improper. In a decision dated July 6, 2006, the Court granted the Company's motion and dismissed four of seven claims contained in Mr. Brunson's complaint. The Company answered Mr. Brunson's remaining claims on July 27, 2006. Mr. Brunson and the Company are currently engaged in discovery and pursuing private mediation of their dispute.

During the first quarter of 2005 and twelve months ended December 31, 2005, the Company recorded approximately \$1.1 million relating to the resignation of Mr. Brunson. Any options or shares of restricted stock granted to Mr. Brunson vested in full as of the date of such resignation.

On November 27, 2005, in Owens v. National Tobacco Company (Cal Super. Ct. Case No. BC343611), two former employees filed claims alleging racial and gender discrimination against the Company following the Company's dismissal of those employees for poor performance. The Company believes it will prevail. If the Company were not to prevail, the result could be a material adverse event. Discovery has commenced in this case.

Alvarez & Marsal ( A&M ) is entitled to a fee based on improvement in the Company's financial performance as measured against the Company's 2005 Business Plan, to be paid upon the termination of the engagement. One portion of the fee will be a specified percentage of the sustainable annualized EBITDAR improvement, as defined, and the other portion of the fee will be an amount to be determined by the Board of Directors of the Company in their reasonable judgment for significant and sustainable improvement in working capital investment and management, in each case as measured against the Company's 2005 Business Plan. As of June 30, 2006, no related liability or expense has been recorded relating to financial performance improvements.

### 13. Segment Information

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

The accounting policies of these segments are the same as those of the Company. Segment data includes a charge allocating corporate costs to the Smokeless Tobacco and Make-Your-Own segments based on their respective Net sales. Prior year amounts have been reclassified to conform to the current year presentation. Other includes the assets of the Company not assigned to segments and Elimination includes the elimination of intercompany accounts between segments. The Company evaluates the performance of its segments and allocates resources to them based on operating income.

The table below presents financial information about reported segments for the three months and six months ended June 30, 2006 and 2005, respectively (in thousands):

For the three months ended:	Smokeless Tobacco	Make Your Own	Premium Manufactured Cigarettes	Other	Eliminations	Total
<b>June 30, 2006</b>						
Net sales	\$ 12,124	\$ 15,713	\$ (4)	\$ 1,293	\$	\$ 29,126
Operating income	1,327	4,542	(203)	370		6,036
Assets	69,900	299,229	3,982	33,237	(181,214)	225,134
<b>June 30, 2005</b>						
Net sales	\$ 11,707	\$ 17,398	\$ 151	\$ 1,265	\$	\$ 30,521
Operating income	(640)	3,540	(1,174)	182		1,908
Assets	84,407	289,571	2,948	21,723	(159,129)	239,520

For the six months ended:	Smokeless Tobacco	Make Your Own	Premium Manufactured Cigarettes	Other	Eliminations	Total
<b>June 30, 2006</b>						
Net sales	\$ 23,655	\$ 31,427	\$ 4	\$ 2,464	\$	\$ 57,550
Operating income	3,566	7,633	(452)	462	\$	11,209
Assets	69,900	299,229	3,982	33,237	(181,214)	225,134
<b>June 30, 2005</b>						
Net sales	\$ 21,543	\$ 33,537	\$ 331	\$ 2,458	\$	\$ 57,869
Operating income	(1,789)	6,718	(2,168)	129	\$	2,890
Assets	84,407	289,571	2,948	21,723	(159,129)	239,520

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

The Company competes, in three distinct markets: (1) the smokeless tobacco market; (2) the Make-Your-Own ( MYO ) cigarette market; and (3) the premium manufactured cigarette market. The smokeless tobacco market includes the loose leaf chewing tobacco sector. The MYO cigarette market is comprised of the MYO premium cigarette papers sector and the MYO cigarette tobaccos and related products sector. The Company's subsidiaries manufacture and market loose leaf chewing tobacco, import and distribute MYO premium cigarette papers, contract manufacture and market MYO cigarette tobaccos and related products, and contract manufacture and market premium manufactured cigarettes. To date, the Company's premium manufactured cigarette segment continues in its development phase and net sales of this segment have not been significant.

**Results of Operations****Comparison of Three Months Ended June 30, 2006 and 2005**

**Net Sales.** Net sales for the three months ended June 30, 2006 were \$29.1 million, a decrease of \$1.4 million or 4.6% from the corresponding period of the prior year.

Net sales of the smokeless tobacco segment for the current period increased \$0.4 million or 3.6% from the corresponding period of the prior year. This increase is due principally to an aggregate average price increase of approximately 5.7% instituted during the latter part of the second quarter of 2005 and approximately 7.9% instituted during the second quarter of 2006 partially offset by a decrease in aggregate gross case sales from 92,241 to 90,180, or 2.2%. The average aggregate list price per case was \$180.49 and \$167.30 as of June 30, 2006 and 2005, respectively.

Net sales of the Company's MYO segment decreased \$1.7 million or 9.7% in comparison to the corresponding period of the prior year. This decrease is due principally to a reduction in aggregate gross case sales from 104,030 to 88,515, or 14.9%, partially offset by an aggregate average price increase of 0.5% instituted during the latter part of the second quarter of 2005 and 0.3% instituted during the second quarter of 2006. The aggregate case volume decreased due to the Company's decision to withdraw its discount MYO tobaccos from the state of Michigan and greater competitive pricing activity in key MYO opportunity geographies. The average aggregate list price per case was \$225.59 and \$217.82 as of June 30, 2006 and 2005, respectively.

**Gross Profit.** Gross profit for the three months ended June 30, 2006 totaled \$16.2 million, an increase of \$0.8 million or 5.3% from the corresponding period of the prior year.

Gross profit of the smokeless tobacco segment increased \$0.8 million or 15.0% from the corresponding period of the prior year. Gross margin for this segment increased to 51.3% of net sales for the current period from 46.2% in the corresponding period of the prior year due to an increase in case sales of higher margin products.

Gross profit of the MYO segment for the current period increased \$0.1 million or 1.4% in comparison to the corresponding period of the prior year. The gross margin of the MYO segment increased to 59.1% of net sales for the current period in comparison to 52.6% for the corresponding period of the prior year. This increase in gross margin was due principally to product mix resulting from decreased sales of its lower margin products.

**Selling, General, and Administrative Expenses.** Selling, general, and administrative expenses for the three months ended June 30, 2006 were \$10.1 million, a decrease of \$3.3 million or 24.7% in comparison to the corresponding period of the prior year. This decrease was primarily due to a \$1.2 million net decrease in expenses associated with counterfeiting activity, \$1.0 million relating to expenses associated with manufactured premium cigarettes, \$0.9 million relating to the reduction in restructuring costs, \$0.6 million related to reduced compensation expenses, decreased licensing and fee expenses of \$0.4 million, partially offset by an increase in legal/litigation expenses of \$0.5 million and increased freight costs of \$0.3 million.

**Interest Expense and Amortization of Financing Costs.** Interest expense and amortization of financing costs decreased \$1.1 million or 14.4% to \$6.6 million for the three months ended June 30, 2006 as compared to the corresponding period of the prior year. This decrease was due principally to lower average outstanding indebtedness due to the repurchase of the Senior Discount Notes.

**Other Income (Expense).** See Note 11 for discussion of reclassification of Other income (expense) as prior periods have been reclassified to Selling, general and administrative expenses.

**Income Tax Benefit (Expense).** The Company has determined that at June 30, 2006, its ability to realize future benefits of net deferred tax assets does not meet the more likely than not criteria in SFAS No. 109, Accounting for Income Taxes. Therefore, only deferred tax expense related to inventories and tax-deductible goodwill is being recorded in 2006, similar to 2005. Tax expense for the three months ended June 30, 2006 was \$0.2 million as compared to a benefit of \$0.2 for the three months ended June 30, 2005. As of June 30, 2006, a valuation allowance continues to be recorded.

**Net Income (Loss).** Due to the factors described above, net loss for the three months ended June 30, 2006 was \$0.8 million compared to \$5.6 million for the corresponding period of the prior year.

**Comparison of Six Months Ended June 30, 2006 and 2005**

**Net Sales.** Net sales for the six months ended June 30, 2006 were \$57.6 million, a decrease of \$0.3 million or 0.5% from the corresponding period of the prior year.

Net sales of the smokeless tobacco segment for the current period increased \$2.1 million, or 9.8%, from the corresponding period of the prior year. This increase is due principally to an aggregate average price increase of approximately 5.7% instituted during the latter part of the second quarter of 2005 and approximately 7.9% instituted during the second quarter of 2006. Aggregate gross case sales remained basically flat from 176,353 to 176,781, or, a 0.2% increase. The average aggregate list price per case was \$180.49 and \$167.30 as of June 30, 2006 and 2005, respectively.

Net sales of the Company's MYO segment decreased \$2.1 million, or 6.3%, in comparison to the corresponding period of the prior year. This decrease is due principally to a reduction in aggregate gross case sales from 211,913 to 186,367, or 12.1%, partially offset by an aggregate average price increase of 0.5% instituted during the latter part of the second quarter of 2005 and 0.3% instituted during the second quarter of 2006. The aggregate case volume decreased due to the Company's decision to withdraw its discount MYO tobaccos from the state of Michigan, lower Canadian paper shipments and greater competitive pricing activity in key MYO opportunity geographies. The average aggregate list price per case was \$225.59 and \$217.82 as of June 30, 2006 and 2005, respectively.

**Gross Profit.** Gross profit for the six months ended June 30, 2006 totaled \$31.6 million, an increase of \$2.0 million or 6.7% from the corresponding period of the prior year.

Gross profit of the smokeless tobacco segment increased \$2.7 million or 26.7% from the corresponding period of the prior year. Gross margin for this segment increased to 53.2% of net sales for the current period from 46.1% in the corresponding period of the prior year due to product mix resulting from increases in list price coupled with a reduction in manufacturing costs.

Gross profit of the MYO segment for the current period decreased \$0.4 million or 2.3% in comparison to the corresponding period of the prior year. The gross margin of the MYO segment increased to 56.1% of net sales for the current period in comparison to 53.8% for the corresponding period of the prior year. This increase in gross margin was due principally to product mix resulting from increases in list price coupled with a reduction in manufacturing costs.

**Selling, General, and Administrative Expenses.** Selling, general, and administrative expenses for the six months ended June 30, 2006 were \$20.1 million, a decrease of \$6.3 million or 24.0% in comparison to the corresponding period of the prior year. This decrease was due primarily to \$2.0 million net decrease in expenses associated with counterfeiting activity, \$2.0 million relating to expenses associated with manufactured premium cigarettes, \$1.5 million relating to the reduction in restructuring costs, \$0.6 million related to reduced compensation costs, decreased licensing and fee expenses of \$0.4 million, partially offset by an increase in legal/litigation expenses of \$0.2 million and increased freight costs of \$0.2 million.

**Interest Expense and Amortization of Financing Costs.** Interest expense and amortization of financing costs decreased \$1.8 million or 11.8% to \$13.4 million for the six months ended June 30, 2006 as compared to the corresponding period of the prior year. This increase was due principally to lower average outstanding indebtedness due to the repurchase of the Senior Discount Notes.

Other Income (Expense). See Note 11 for discussion of reclassification of Other income (expense) as prior periods have been reclassified to Selling, general and administrative expenses.

Income Tax Benefit (Expense). The Company has determined that at June 30, 2006, its ability to realize future benefits of net deferred tax assets does not meet the more likely than not criteria in SFAS No. 109, Accounting for Income Taxes. Therefore, only deferred tax expense related to inventories and tax-deductible goodwill is being recorded in 2006, similar to 2005. Tax expense for the six months ended June 30, 2006 and June 30, 2005 was \$0.4 million and \$0.0 million, respectively. As of June 30, 2006, a valuation allowance continues to be recorded.

Net Income (Loss). Due to the factors described above, net loss for the six months ended June 30, 2006 was \$2.6 million compared to \$12.3 million for the corresponding period of the prior year.

### **Liquidity and Capital Resources**

At June 30, 2006, working capital was \$21.0 million compared to \$19.5 million at December 31, 2005. This increase was the result of a decrease in accounts payable and accrued expenses of \$5.4 million offset by an increase in the revolving credit facility of \$4.0 million.

For the six months ended June 30, 2006, net cash used in operating activities was \$2.7 million compared with \$4.4 million in the corresponding period of the prior year. The change was due primarily to a decrease in net loss partially offset by a reduction in accounts payable.

For the six months ended June 30, 2006, net cash used in investing activities was \$0.6 million compared with \$1.3 million in the corresponding period of the prior year. The change was due to the reduction in capital expenditures. The Company believes that its capital expenditure requirements for 2006 will be approximately \$2.5 - \$3.0 million due to the purchasing of certain manufacturing equipment and the continuing investment in data and related systems.

For the six months ended June 30, 2006, net cash provided by financing activities was \$4.0 million compared with \$13.7 million in the corresponding period of the prior year. The change was due primarily to borrowings related to the term loan in 2005 partially offset by the increase in borrowings of the revolving credit facilities.

The Company expects to be able to fund its seasonal working capital expenditure requirements in 2006 through its operating cash flows and, if needed, bank borrowings under the Financing Agreement. As of June 30, 2006, the Company had additional availability of \$51.0 million under the revolving credit portion of its Financing Agreement.



### **Contractual Obligations**

Certain contractual obligations are summarized in our Annual Report on Form 10-K for the year ended December 31, 2005 under the heading "Contractual Obligations" in Management's Discussion and Analysis of Financial Condition and Results of Operations. As of June 30, 2006, there had been no material changes outside the ordinary course of our business in such contractual obligations from December 31, 2005.

### **Forward-looking Statements**

The Company cautions the reader that certain statements in the Management's Discussion and Analysis of Financial Condition and Results of Operations section as well as elsewhere in this Form 10-Q are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are not guarantees of future performance. They involve risks, uncertainties and other important factors, including the risks discussed below and in Item 1A, Risk Factors, in the Company's Annual Report on Form 10-K for the year ended December 31, 2005. The Company's actual future results, performance or achievement of results may differ materially from any such results, performance or achievement implied by these statements. Among the factors that could affect the Company's actual results and could cause results to differ from those anticipated in the forward-looking statements contained herein is the Company's ability to comply with certain Financing Agreement financial covenants, its ability to implement its business strategy successfully, which may be dependent on business, financial, and other factors beyond the Company's control, including, among others, federal, state and/or local regulations and taxes, competitive pressures, prevailing changes in consumer preferences, consumer acceptance of new product introductions and other marketing initiatives, market acceptance of the Company's current distribution programs, access to sufficient quantities of raw material or inventory to meet any sudden increase in demand, disruption to historical wholesale ordering patterns, product liability litigation and any disruption in access to capital necessary to achieve the Company's business strategy.

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

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

There have not been any significant changes with respect to quantitative and qualitative disclosures about market risk from what was previously disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

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

##### Disclosure Controls and Procedures

The Company's management, with the participation of the Company's principal executive and principal financial officers, has evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act as of June 30, 2006, and has concluded that the Company's disclosure controls and procedures were not effective as of June 30, 2006 because of the material weakness in the Company's internal control over financial reporting discussed below under Internal Control Over Financial Reporting.

##### Internal Control Over Financial Reporting

A material weakness is a control deficiency, or combination of control deficiencies, that results in a more than remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The Company has determined that, as of June 30, 2006, it has a deficiency in internal controls over the valuation of deferred income tax assets. Specifically, the Company did not have adequate controls over the accounting for and the review and approval of income tax related financial statement accounts requiring a significant degree of technical knowledge related to deferred tax assets and liabilities. As a result of the ineffective review, an error in the deferred tax valuation allowance was not detected prior to the issuance of the 2004 consolidated financial statements. This control deficiency resulted in the restatement of the Company's 2004 annual and first quarter 2005 consolidated financial statements. In addition this control deficiency could result in a misstatement to deferred tax valuation allowance that could result in a material misstatement to the annual or interim financial statements that would not be prevented or detected. Accordingly, management determined that this control deficiency constitutes a material weakness.

##### Management's Remediation Plan

During the fiscal quarter ended September 30, 2005, the Company took remedial steps to eliminate this material weakness, including engaging the services of an independent public accounting firm, other than the Company's auditors, with appropriate levels of income tax accounting knowledge and expertise to assist in the review of complex tax matters. For the year ended December 31, 2005 and the six months ended June 30, 2006, the Company's income tax provision and valuation of deferred income tax assets and liabilities was reviewed by the above mentioned firm. As of June 30, 2006, these remediation efforts, and the Company's evaluation of its internal controls over the valuation of deferred income tax assets, are continuing.

##### Changes in Internal Control

There has been no change in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15-d-15(f) under the Exchange Act) that occurred during the Company's fiscal quarter ended June 30, 2006, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II

OTHER INFORMATION

**Item 1. Legal Proceedings**

Reference is made to the information contained in Note 12 to the Condensed Consolidated Financial Statements included herein, which information is incorporated herein by reference.

**Item 6. Exhibits**

- 10.1 Letter Agreement, dated April 5, 2006, between NATC and Jack Africk (incorporated by reference to the Company's Current Report on Form 8-K filed on April 11, 2006).
- 10.2 Amendment, dated April 11, 2006, to the Employment Agreement, dated as of November 21, 2002, between NATC and James W. Dobbins (incorporated by reference to the Company's Current Report on Form 8-K filed on April 11, 2006).
- 10.3 Amendment, dated April 20, 2006, to Amended and Restated Distribution and License Agreements (United States and Canada), between Bolloré S.A. and North Atlantic Operating Company, Inc. (incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2006).
- 10.4 Amendment, dated June 26, 2006, but effective as of May 11, 2006, to the Amended Letter Agreement, dated April 11, 2005, between Alvarez & Marsal, LLC, the Company, NATC and their respective subsidiaries (incorporated by reference to the Company's Current Report on Form 8-K filed on June 28, 2006).
- 10.5 Amendment, dated July 28, 2006, to the Consulting Agreement, dated as of June 25, 1997, between NATC and Jack Africk (incorporated by reference to the Company's Current Report on Form 8-K filed on August 1, 2006).
- 31.1 Certification by the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification by the Chief Financial Officer pursuant to Section 302 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.

NORTH ATLANTIC HOLDING COMPANY, INC.

Date: August 14, 2006

/s/ Douglas P. Rosefsky.  
Douglas P. Rosefsky  
Chief Executive Officer

/s/ Brian C. Harriss  
Brian C. Harriss  
Chief Financial Officer

EXHIBIT INDEX

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