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BLUEFLY INC  
Form 10-K  
February 28, 2006

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

FORM 10-K

- ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended December 31, 2005
- TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 001-14498

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BLUEFLY, INC.  
(Name of registrant as specified in its charter)

|  |                                      |
|--|--------------------------------------|
| Delaware   | 13-3612110                           |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

|  |            |
|--|------------|
| 42 West 39th Street, New York, NY        | 10018      |
| (Address of principal executive offices) | (Zip Code) |

Registrant's telephone number: (212) 944-8000

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Securities registered under Section 12(b) of the Exchange Act:

| Title of Each Class                     | Name of Each Exchange on Which Registered            |
|---|--|
| -----                                   | -----  |
| Common Stock, par value \$.01 per share | The Nasdaq Stock Market LLC<br>Boston Stock Exchange |

Securities registered under Section 12(g) of the Exchange Act: None

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

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

Indicate by check mark whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 disclosure of delinquent filers in response to Item 405 of Regulation S-K is not contained in this form, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or

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information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes [ ] No [X]

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

As of February 24, 2006, there were 21,202,009 shares of Common Stock, \$.01 par value, of the registrant outstanding. The aggregate market value of the voting and non-voting common equity held by non-affiliates as of June 30, 2005, based upon the last sale price of such equity reported on the Nasdaq Capital Market, was approximately \$16,424,000.

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### PART I

#### ITEM 1. DESCRIPTION OF BUSINESS

##### GENERAL

Bluefly, Inc. is a leading online retailer of designer brands, fashion trends and superior value. During 2005, we offered over 37,000 different styles for sale in categories such as men's, women's and accessories as well as house and home accessories from over 350 brands at discounts up to 75% off retail value. We launched the Bluefly.com Web site (the "Web site") in September 1998. Since its inception, www.bluefly.com has served over 785,000 customers and shipped to over 17 countries.

Our common stock is listed on the Nasdaq Capital Market under the symbol "BFLY" and on the Boston Stock Exchange under the symbol "BFL" and we are incorporated in Delaware. Our executive offices are located at 42 West 39th Street, New York, New York 10018, and our telephone number is (212) 944-8000. Our Internet address is www.bluefly.com. We make available, free of charge, through our Web site, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC.

In this report, the terms "we," "us," "Bluefly" and the "Company" refer to Bluefly, Inc. and its predecessors and subsidiaries, unless the context indicates otherwise.

##### RECENT DEVELOPMENTS

In February 2006, we extended the maturity dates on the Convertible Promissory Notes issued in July and October 2003 (the "Notes") to affiliates of Soros Private Equity Partners, LLC (collectively, the "Soros Funds") that collectively own a majority of our capital stock. The maturity dates of the Notes were each extended for one year, from May 1, 2006 to May 1, 2007.

##### BUSINESS STRATEGY

Our goal is to offer our customers the best designer brands and latest fashion trends at superior values. We offer the same types of on-trend and in-season designer merchandise as are sold in luxury department stores at discounts normally found only at outlet stores and off-price stores. We are able to acquire our products at significantly lower prices than a luxury department

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store (and pass these discounts on to our customers) because we purchase our inventory slightly later in the season than a typical full price retailer. For example, we purchase much of our Spring line in January for March delivery. This allows us to have our best assortment of on trend merchandise at a discount when the customer is ready to shop for a new season. Similarly, we are able to offer an upscale shopping experience not available at off-price stores or outlet malls because of our merchandise selection and the presentation and product search capabilities offered by our Web site. The frequent addition of new on-trend products to our site is also key to our marketing strategy as it gives our shoppers reason to visit the site and keeps our customer file loyal and active.

Our business is also designed to provide a compelling value proposition for our suppliers and, in particular, the more than 350 top designer brands that we offer on our Web site. Because we work with our suppliers both at the beginning and throughout the season we are able to help them manage inventory and cash flow. We also create an environment that is respectful of the brands we sell. Our buyers all have backgrounds in a full price branded retail environment. Our Web site creates a high-end retail environment that offers only the best designer brands and the most current trends. In doing so, we support our vendors' brands, rather than diluting them as traditional off-price channels do.

We do not believe that we can accomplish these goals without using the Internet as a platform. The direct marketing of products that are available in limited quantities and sizes, and that are not replenishable, requires a cost-effective medium that can display a large number of products. We believe print catalogs are not well suited to this task. The paper, printing, mailing and other production costs of a print catalog can be significant and the lead times required to print a catalog make them significantly inflexible in addressing inventory sell outs, price changes and new styles. To work around these limitations, a traditional cataloger typically requires products that are replenishable, available in a full range of sizes and in substantial quantities. Similarly, retailing on television is costly and requires substantial quantities of products that are available in all sizes in order for it to be an economical medium. In addition, the number of items that can be displayed on television is limited, and television does not allow viewers to search for products that interest them.

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The Internet, however, can be a far less expensive and far more effective medium. By using the Internet as our platform, the number of items that we offer is not limited by the high costs of printing and mailing catalogs. With the Internet, we can automatically update product images as new products arrive and other items sell out. By using a real-time inventory database, we can create a personalized shopping environment and allow our customers to search for the products that specifically interest them and are available in their size. In addition, we believe that we are able to more economically and consistently maintain an upscale environment through the design of a single online storefront.

We believe that we have created a customer experience that is fundamentally better than that offered by traditional off-price retailers. Similarly, we believe that our upscale atmosphere, professional photography and premium merchandise offering create a superior distribution channel for designers who wish to liquidate their end-of-season and excess merchandise without suffering the brand dilution inherent in traditional off-price channels. Our customer research suggests that this strategy has been acceptable. For example, respondents to a recent third party study that we commissioned rated us at the level of, or higher than, luxury department stores for assortment, quality and service and rated us much higher than discounters for value.

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### E-COMMERCE AND THE ONLINE APPAREL MARKET

The dramatic growth of e-commerce has been widely reported and is expected to continue. According to the ComScore Networks, online sales grew in 2005 to \$143.2 billion over the \$117.2 billion spent in 2004. During the holiday shopping season alone, consumers spent \$28.2 billion, a 22% increase over the \$23.1 billion spent in the previous year, according to ComScore. We believe that a number of factors will contribute to the growth of e-commerce, including (i) shoppers' growing familiarity and comfort with shopping online, (ii) the proliferation of devices to access the Internet, and (iii) technological advances that make navigating the Internet faster and easier.

Online sales of apparel and accessories was one of the fastest growing categories in 2005. According to ComScore, apparel and accessories as a product category grew by 36% above 2004 sales of \$12.2 billion, which makes it and computer software the two largest categories of merchandise sold online. According to Forrester Research ("Forrester"), the percentage of US households shopping online is expected to grow from 39% in 2005 to 48% in 2010. In addition, Forrester estimates that 11% of all apparel sales will be made online by 2010. We believe that the market for online sales of apparel is growing faster than many other retail categories as a result of a confluence of trends, including (i) the growth of the number of women online, who account for a larger share of retail apparel purchases, (ii) the expansion of online traffic from technology oriented users to users with mainstream demographic, (iii) the development of sophisticated tools to search complex product categories such as apparel and (iv) the growing adoption of high speed access of cable modems and DSL, which makes viewing large numbers of photos much faster. Of course, there can be no assurance that such expectations will prove to be correct or that they will have a positive effect on our business.

### MARKETING

Our marketing efforts are focused both on acquiring new customers and retaining existing customers. Active Bluefly customers visit the site frequently and purchase from one season to the next at high levels with great predictability. A significant portion of our sales to existing customers are driven by our customer emails, which highlight new promotions and products and provide special previews to customers who have asked to be included in our email list. In addition, we believe that our sales to existing customers are driven by all aspects of our customer experience, including our Web site design, packaging, delivery and customer service.

During the past several years, we have acquired new customers primarily through online advertising, word-of-mouth, sweepstakes and our affiliate program. Although we had not allocated significant resources to branding or to more traditional advertising channels such as print during this time, our customer file continued to grow. In September 2005, we began a national advertising campaign that featured both print and television. Consumer response was positive as evidenced in our fourth quarter results. The campaign will continue for the first half of 2006.

### MERCHANDISING

We buy merchandise directly from designers as well as from retailers and other third party, indirect resources. Currently, we offer products from more than 350 name brand designers, which we believe to be the widest selection of designers available

from any online store. We have established direct supply relationships with over

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200 such designers. We believe that we have been successful in opening up over 200 direct supply relationships, in part because we have devoted substantial resources to establishing Bluefly.com as a high-end retail environment. We are committed to displaying all of our merchandise in an attractive manner, offering superior customer service and gearing all aspects of our business towards creating a better channel for top designers.

During 2004, we re-focused our merchandising strategy to offer more in-season merchandise and to cover the latest trends, while continuing to offer a premium selection of brands. During 2005, we further refined this strategy. As a result of this merchandise strategy, we were able to increase our gross margins to their highest levels ever - 39.1% in 2005, from 37.5% and 29.9% in 2004 and 2003, respectively.

### WAREHOUSING AND FULFILLMENT

When we receive an order, the information is transmitted to our third party warehouse and fulfillment center located in Virginia, where the items included in the order are picked, packed and shipped directly to the customer. Our inventory database is updated on a real-time basis, allowing us to display on our Web site only those styles, sizes and colors of product available for sale.

We focus on customer satisfaction throughout our organization. In December 2005, during our peak weeks of the holiday season, the vast majority of our orders were shipped within one business day from receipt of the customer's order.

### CUSTOMER SERVICE

We believe that a high level of customer service and support is critical to differentiating ourselves from traditional off-price retailers and maximizing customer acquisition and retention efforts. Our customer service effort starts with our Web site, which is designed to provide an intuitive shopping experience. An easy to use help center is available on the Web site and is designed to answer many of our customers' most frequently asked questions. For customers who prefer e-mail or telephone assistance, customer service representatives are available seven days a week to provide assistance. We utilize customer representatives from a third party call center that has a team dedicated to our business. We also maintain a team of premiere representatives in our New York office, who provide special services and assist in the training and management of the other representatives. To ensure that customers are satisfied with their shopping experience, we generally allow returns for any reason within 90 days of the sale for a full refund. We were recently rated by the e-tailing group, inc. as one of the top 10 merchants that excelled at online customer service.

### TECHNOLOGY

We have implemented a broad array of state-of-the-art technologies that facilitate Web site management, complex database search functionality, customer interaction and personalization, transaction processing, fulfillment and customer service functionality. Such technologies include a combination of proprietary technology and commercially available, licensed technology. To address the critical issues of privacy and security on the Internet, we incorporate, for transmission of confidential personal information between customers and our Web server, Secure Socket Layer Technology ("SSL") such that all data is transmitted via a 128-bit encrypted session. The computer and communications equipment on which our Web site is hosted are currently located at a third party co-location facility in New York.

### COMPETITION

Electronic commerce generally, and, in particular, the online retail apparel and

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fashion accessories market, is a relatively new, dynamic, high-growth market. Our competition for online customers comes from a variety of sources, including existing land-based retailers that are using the Internet to expand their channels of distribution, established Internet companies and less established companies. In addition, our competition for customers comes from traditional direct marketers designer brands that may attempt to sell their products directly to consumers through the Internet and land-based off-price retail stores, which may or may not use the Internet in the future to grow their customer base. Many of these competitors have longer operating histories, significantly greater resources, greater brand recognition and more firmly established supply relationships. Moreover, we expect additional competitors to emerge in the future.

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We believe that the principal competitive factors in our market include: brand recognition, merchandise selection, price, convenience, customer service, order delivery performance and site features. Although we believe that we compare favorably with our competitors, we recognize that this market is relatively new and is evolving rapidly, and, accordingly, there can be no assurance that this will continue to be the case.

### INTELLECTUAL PROPERTY

We rely on various intellectual property laws and contractual restrictions to protect our proprietary rights in services and technology, including confidentiality, invention assignment and nondisclosure agreements with employees and contractors. Despite these precautions, it may be possible for a third party to copy or otherwise obtain and use our intellectual property without our authorization. In addition, we pursue the registration of our trademarks and service marks in the U.S. and internationally and the registration of our domain name and variations thereon. However, effective intellectual property protection may not be available in every country in which the services are made available online.

We rely on technologies that we license from third parties. These licenses may not continue to be available to us on commercially reasonable terms in the future. As a result, we may be required to obtain substitute technology of lower quality or at greater cost, which could materially adversely effect our business, financial condition, results of operations and cash flows.

We do not believe that our business, sales policies or technologies infringe the proprietary rights of third parties. However, third parties have in the past and may in the future claim that our business, sales policies or technologies infringe their rights. We expect that participants in the e-commerce market will be increasingly subject to infringement claims as the number of services and competitors in the industry grows. Any such claim, with or without merit, could be time consuming, result in costly litigation or require us to enter into royalty or licensing agreements. Such royalty or licensing agreements might not be available on terms acceptable to us, or at all. As a result, any such claim of infringement against us could have a material adverse effect upon our business, financial condition, results of operations and cash flows.

### GOVERNMENTAL APPROVALS AND REGULATIONS

We are not currently subject to direct regulation by any domestic or foreign governmental agency, other than regulations applicable to businesses generally, and laws or regulations directly applicable to online commerce. We are not aware of any permits or licenses that are required in order for us, generally, to sell apparel and fashion accessories on the Internet, although licenses are sometimes required to sell products made from specific materials. In addition, permits or

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licenses may be required from international, federal, state or local governmental authorities to operate or to sell certain other products on the Internet in the future. No assurances can be given that we will be able to obtain such permits or licenses. We may be required to comply with future national and/or international legislation and statutes regarding conducting commerce on the Internet in all or specific countries throughout the world. No assurance can be made that we will be able to comply with such legislation or statutes. Our Internet operations are not currently impacted by federal, state, local and foreign environmental protection laws and regulations.

### EMPLOYEES

As of February 17, 2006, we had 83 full-time employees and 2 part-time employees, as compared to 73 full-time and 4 part-time employees as of February 17, 2005. None of our employees are represented by a labor union, and we consider our relations with our employees to be good.

### ITEM 1A. RISK FACTORS

We Have A History Of Losses And Expect That Losses Will Continue In The Future. As of December 31, 2005, we had an accumulated deficit of \$99,947,000. We incurred net losses of \$3,820,000, \$3,791,000 and \$6,369,000 for the years ended December 31, 2005, 2004 and 2003, respectively. We have incurred substantial costs to develop our Web site and infrastructure. In order to expand our business, we intend to invest in sales, marketing, merchandising, operations, information systems, site development and additional personnel to support these activities. We therefore may continue to incur substantial operating losses for the next year. Our ability to become profitable depends on our ability to generate and sustain substantially higher net sales while maintaining reasonable expense levels, both of which are uncertain. If we do achieve profitability, we cannot be certain that we would be able to sustain or increase profitability on a quarterly or annual basis in the future.

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Certain Events Could Result In Significant Dilution Of Your Ownership Of Our Common Stock. Stockholders could be subject to significant dilution to the extent that we raise additional equity financing, as a result of both the issuance of additional equity securities, the potential conversion of the Notes, as described below, and the anti-dilution provisions of our Series B, C, D, E and F Preferred Stock described below, which provide for the issuance of additional securities to the holders thereof, under certain circumstances, to the extent that the Preferred Stock is converted at any time after a sale of Common Stock at less than \$2.32 (in the case of the Series F preferred stock) or \$0.76 per share (in the case of the Series B, C, D and E preferred stock).

Moreover, as of February 17, 2006, there were outstanding options to purchase 8,118,684 shares of our Common Stock issued under our Stock Option Plans, warrants to purchase 606,644 shares of our Common Stock issued to the Soros Funds, and additional warrants and options to purchase 1,376,749 shares of our Common Stock. In addition, as of such date, our outstanding Preferred Stock was convertible into an aggregate of 43,367,707 shares of our Common Stock (plus any shares of our Common Stock issued upon conversion in payment of any accrued and unpaid dividends). The exercise of our outstanding options and warrants and/or the conversion of our outstanding Preferred Stock would dilute the then existing stockholders' percentage ownership of our Common Stock, and any sales in the public market of our Common Stock underlying such securities, could adversely affect prevailing market price of our Common Stock. In the event that all of the securities described above were converted to Common Stock, the holders of the Common Stock immediately prior to such conversion would own approximately 28% of the outstanding Common Stock immediately after such conversion, excluding the

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effect of accrued dividends on Preferred Stock. Accrued dividends aggregated \$18.6 million at December 31, 2005.

The Soros Funds also own the Notes, which bear interest at the rate of 12% per annum and are convertible, at Soros Funds' option, into our equity securities sold in any subsequent round of financing at a price that is equal to the lowest price per share accepted by any investor (including the Soros Funds or any of their affiliates) in such subsequent round of financing.

We Need to Authorize Additional Shares of Common Stock. We have 92,000,000 shares of Common Stock authorized. As of December 31, 2005, we have 18,502,794 shares available for future issuance, after giving effect to the shares reserved for shares issuable upon exercise of convertible securities, but without giving effect to shares issuable in satisfaction of outstanding dividends on the Preferred Stock, which the company has the right to pay in cash or in shares of Common Stock. We intend to submit for approval by the holders of the Common Stock an increase in the number of authorized shares of Common Stock at our next annual meeting, which is scheduled for May 2006. The inability to obtain such approval could constrain our future growth.

Anti-Dilution Provisions Relating To Our Preferred Stock Could Result In Further Dilution To Your Ownership Of Our Common Stock. As described above, our Series B, C, D and E Preferred Stock contain anti-dilution provisions pursuant to which, subject to certain exceptions, in the event that we issue or sell our Common Stock or new securities convertible into our Common Stock in the future for less than \$0.76 per share, the conversion price of that preferred stock would be decreased to the price at which such Common Stock or other new securities are sold. In addition, our Series F Preferred Stock contains anti-dilution provisions pursuant to which, subject to certain exceptions, in the event that we issue or sell our Common Stock or new securities convertible into our Common Stock in the future for less than \$2.32 per share, but for \$1.50 or more per share, the conversion price of the Series F Preferred Stock would be decreased on a weighted average basis, taking into account the number of new shares issued and the price at which such shares are issued. In the event that we issue or sell our Common Stock or new securities convertible into our Common Stock in the future for less than \$1.50 per share, the conversion price of the Series F Preferred Stock would be decreased to the price at which such Common Stock or other new securities are sold. The anti-dilution provisions of the Series F Preferred Stock are subject to the approval of our stockholders. We expect that approval to be obtained at our next shareholder meeting, as the Soros Funds have agreed to vote all of their shares of our stock (which represent a majority of the votes) in favor of such approval.

The Soros Funds Own A Majority Of Our Stock And Therefore Effectively Control Our Management And Policies. As of February 17, 2006, through their holdings of our common stock, as well as our preferred stock, and warrants convertible into our common stock, the Soros Funds beneficially owned, in the aggregate, approximately 76% of our common stock. The holders of our preferred stock vote on an "as converted" basis with the holders of our common stock. By virtue of their ownership of our Series A and B Preferred Stock, the Soros Funds have the right to appoint two designees to our Board of Directors, each of whom has seven votes on any matter voted upon by our Board of Directors. Collectively, these two designees have 14 out of 19 possible votes on each matter voted upon by our Board of Directors. In addition, we are required to obtain the approval of holders of our Series A, B, C, D and E preferred stock prior to taking certain actions, and the Soros Funds own a majority of the outstanding shares of each of these classes of stock. The holders of our Series A, B, C, D and E Preferred

Stock have certain pre-emptive rights to participate in future equity financings



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and, along with the holders of the Series F Preferred Stock, have certain anti-dilution rights described above that could result in the issuance of additional securities to such holders. In view of their large percentage of ownership and rights as the holders of our Preferred Stock, the Soros Funds effectively control our management and policies, such as the election of our directors, the appointment of new management and the approval of any other action requiring the approval of our stockholders, including any amendments to our certificate of incorporation, a sale of all or substantially all of our assets or a merger. In addition, the Soros Funds have demand registration rights with respect to the shares of our common stock that they beneficially own. Any decision by the Soros Funds to exercise such registration rights and to sell a significant amount of our shares in the public market could have an adverse effect on the price of our common stock. See "Risk Factors - Certain Events Could Result In Significant Dilution of Your Ownership Of Common Stock."

Our Lenders Have Liens On Substantially All Of Our Assets And Could Foreclose In The Event That We Default Under Our Loan Facility. Under the terms of our loan facility, our lender has a first priority lien on substantially all of our assets, including our cash balances. In connection with the loan facility, we entered into a reimbursement agreement with one of the Soros Funds, pursuant to which it posted a \$2.0 million letter of credit as additional collateral under the loan facility, and we agreed to reimburse it for any amounts it paid to our lender pursuant to such guarantee. We granted the Soros Fund a subordinated lien on substantially all of our assets, including our cash balances, in order to secure our reimbursement obligations. If we default under the loan facility, our lender and/or the Soros Fund would be entitled, among other things, to foreclose on our assets in order to satisfy our obligations under the loan facility.

Our Ability To Maintain Our Minimum Availability Requirement and Pay Our Indebtedness Under Our Loan Facility Is Dependent Upon Meeting Our Business Plan. We are required to pay interest under our loan facility on a monthly basis and maintain minimum availability of \$850,000. Assuming we meet our business plan, we will be able to pay our interest and meet our minimum availability requirement. To a certain extent, however, our ability to meet our business plan, is subject to general economic, financial, competitive, legislative, regulatory and other factors that are beyond our control, and therefore we cannot assure you that based on our business plan we will generate sufficient cash flow from operations to enable us to pay our indebtedness under the loan facility and maintain our minimum availability requirement throughout the term of the agreement. If we fall short of our business plan and are unable to raise additional capital, we could default under our loan facility. In the event of a default under the loan facility, our lender would be entitled, among other things, to foreclose on our assets (whether inside or outside a bankruptcy proceeding) in order to satisfy our obligations under the loan facility. See "Risk Factors - Our Lenders Have Liens On Substantially All Of Our Assets And Could Foreclose In The Event That We Default Under Our Loan Facility."

We Are Making A Substantial Investment In Our Business And May Need To Raise Additional Funds. We may seek to raise additional capital in order to further expand our customer acquisition efforts. Moreover, in the event that the marketing effort is not successful it may be necessary for us to raise additional capital in order to fund planned expenditures. The environment for raising investment capital has been difficult and there can be no assurance that additional financing or other capital will be available upon terms acceptable to us, or at all. In the event that we are unable to obtain additional financing, if needed, we could be forced to decrease expenses that we believe are necessary for us to realize on our long-term prospects for growth and profitability and/or liquidate inventory in order to generate cash. Moreover, any additional equity financing that we may raise could result in significant dilution to the existing holders of common stock. See "Risk Factors - Certain Events Could Result In Significant Dilution Of Your Ownership Of Common Stock."

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If We Are Not Accurate In Forecasting Our Revenues, We May Be Unable To Adjust Our Operating Plans In A Timely Manner. Because our business has not yet reached a mature stage, it is difficult for us to forecast our revenues accurately. We base our current and future expense levels and operating plans on expected revenues, but in the short-term a significant portion of our expenses are fixed. Accordingly, we may be unable to adjust our spending in a timely manner to compensate for any unexpected revenue shortfall. This inability could cause our operating results in some future quarter to fall below the expectations of securities analysts and investors. In that event, the trading price of our common stock could decline significantly. In addition any such unexpected revenue shortfall could significantly affect our short-term cash flow and our net worth, which could require us to seek additional financing and/or cause a default under our loan facility. See "Risk Factors - We Are Making A Substantial Investment In Our Business And May Need To Raise Additional Funds" and "Risk Factors - Our Ability To Comply With Our Financial Covenants And Pay Our Indebtedness Under Our Loan Facility Is Dependent Upon Meeting Our Business Plan."

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Our National Advertising Campaign and Other Marketing Initiatives May Not Be Successful. Our success depends on our ability to attract customers on cost-effective terms. We have relationships with online services, search engines, and other Web sites and e-commerce businesses to provide other links that direct customers to our Web site. In addition, during 2005 we launched our first national television and advertising campaign. Such campaigns are expensive and may not result in the cost effective acquisition of customers. We are relying on the campaign as a significant source of traffic to our Web site and new customers. If these campaigns and initiatives are not successful, our results of operations will be adversely affected.

Unexpected Changes In Fashion Trends Could Cause Us To Have Either Excess or Insufficient Inventory. Fashion trends can change rapidly, and our business is sensitive to such changes. There can be no assurance that we will accurately anticipate shifts in fashion trends and adjust our merchandise mix to appeal to changing consumer tastes in a timely manner. If we misjudge the market for our products or are unsuccessful in responding to changes in fashion trends or in market demand, we could experience insufficient or excess inventory levels or higher markdowns, either of which would have a material adverse effect on our business, financial condition and results of operations.

We Will Be Subject To Cyclical Variations In The Apparel And E-Commerce Markets. The apparel industry historically has been subject to substantial cyclical variations. Furthermore, Internet usage slows down in the summer months. We and other apparel vendors rely on the expenditure of discretionary income for most, if not all, sales. Economic downturns, whether real or perceived, in economic conditions or prospects could adversely affect consumer spending habits and, therefore, have a material adverse effect on our revenue, cash flow and results of operations. Alternatively, any improvement, whether real or perceived, in economic conditions or prospects could adversely impact our ability to acquire merchandise and, therefore, have a material adverse effect on our business, prospects, financial condition and results of operations, as our supply of merchandise is dependent on the inability of designers and retailers to sell their merchandise in full-price venues. See "Risk Factors - We Do Not Have Long Term Contracts With The Majority Of Our Vendors And Therefore The Availability of Merchandise Is At Risk."

We Purchase Product From Some Indirect Supply Sources, Which Increases Our Risk of Litigation Involving The Sale Of Non-Authentic Or Damaged Goods. We purchase merchandise both directly from brand owners and indirectly from retailers and third party distributors. The purchase of merchandise from parties other than

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the brand owners increases the risk that we will mistakenly purchase and sell non-authentic or damaged goods, which could result in potential liability under applicable laws, regulations, agreements and orders. Moreover, any claims by a brand owner, with or without merit, could be time consuming, result in costly litigation, generate bad publicity for us, and have a material adverse impact on our business, prospects, financial condition and results of operations.

If Our Co-Location Facility, Third Party Distribution Center Or Third Party Call Center Fails, Our Business Could Be Interrupted For A Significant Period Of Time. Our ability to receive and fulfill orders successfully and provide high-quality customer service, largely depends on the efficient and uninterrupted operation of our computer and communications hardware systems and fulfillment center. Substantially all of our computer and communications hardware is located at a single co-location facility owned by a third party in New York City. Primarily all of our inventory is held, and our customer orders are filled, at a third party distribution center located in Virginia, and a large majority of our customer service representatives are employees of a third party call center in Ohio. These operations are vulnerable to damage or interruption from fire, flood, storms, power loss, telecommunications failure, terrorist attacks, acts of war, break-ins, earthquake and similar events. We do not presently have redundant systems in multiple locations or a formal disaster recovery plan. Accordingly, a failure at one of these facilities could interrupt our business for a significant period of time, and our business interruption insurance may be insufficient to compensate us for losses that may occur. Any such interruption would negatively impact our sales, results of operations and cash flows for the period in which it occurred, and could have a long-term adverse effect on our relationships with our customers and suppliers.

Security Breaches To Our Systems And Database Could Cause Interruptions to Our Business And Impact Our Reputation With Customers, And We May Incur Significant Expenses to Protect Against Such Breaches. A fundamental requirement for online commerce and communications is the secure transmission of confidential information over public networks. There can be no assurance that advances in computer capabilities, new discoveries in the field of cryptography, or other events or developments will not result in a compromise or breach of the algorithms we use to protect customer transaction and personal data contained in our customer database. A party who is able to circumvent our security measures could misappropriate proprietary information or cause interruptions in our operations. If any such compromise of our security were to occur, it could have a material adverse effect on our reputation with customers, thereby affecting our long-term growth prospects. In addition, we may be required to expend significant capital and other resources to protect against such security breaches or to alleviate problems caused by such breaches.

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Brand Owners Could Establish Procedures To Limit Our Ability To Purchase Products Indirectly. Brand owners have implemented, and are likely to continue to implement, procedures to limit or control off-price retailers' ability to purchase products indirectly. In addition, several brand owners in the U.S. have distinctive legal rights rendering them the only legal importer of their respective brands into the U.S. If we acquire such product indirectly from distributors and other third parties who may not have complied with applicable customs laws and regulations, such goods could be subject to seizure from our inventory by U.S. Customs Service, and the importer may have a civil action for damages against us. See "Risk Factors - We Do Not Have Long Term Contracts With The Majority of Our Vendors And Therefore The Availability Of Merchandise Is At Risk."

Our Growth May Place A Significant Strain On Our Management And Administrative Resources And Cause Disruptions In Our Business. Historically, our growth has

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placed, and any further growth is likely to continue to place, a significant strain on our management and administrative resources. To be successful, we must continue to implement information management systems and improve our operating, administrative, financial and accounting systems and controls. We will also need to train new employees and maintain close coordination among our executive, accounting, finance, marketing, merchandising, operations and technology functions. Any failure to implement such systems and training, and to maintain such coordination, could affect our ability to plan for, and react quickly to, changes in our business and, accordingly, could cause an adverse impact on our cash flow and results of operations in the periods during which such changes occur. In addition, as our workforce grows, our exposure to potential employment liability issues increases, and we will need to continue to improve our human resources functions in order to protect against such increased exposure. Moreover, our business is dependent upon our ability to expand our third-party fulfillment operations, customer service operations, technology infrastructure, and inventory levels to accommodate increases in demand, particularly during the peak holiday selling season. Our planned expansion efforts in these areas could cause disruptions in our business. Any failure to expand our third-party fulfillment operations, customer service operations, technology infrastructure or inventory levels at the pace needed to support customer demand could have a material adverse effect on our cash flow and results of operations during the period in which such failures occur and could have a long-term effect on our reputation with our customers.

We Are Heavily Dependent On Third-Party Relationships, And Failures By A Third Party Could Cause Interruptions To Our Business. We are heavily dependent upon our relationships with our fulfillment operations provider, third party call center and Web hosting provider, delivery companies like UPS and the United States Postal Service, and credit card processing companies such as Paymentech and Cybersource to service our customers' needs. To the extent that there is a slowdown in mail service or package delivery services, whether as a result of labor difficulties, terrorist activity or otherwise, our cash flow and results of operations would be negatively impacted during such slowdown, and the results of such slowdown could have a long-term negative effect on our reputation with our customers. The failure of our fulfillment operations provider, third party call center, credit card processors or Web hosting provider to properly perform their services for us could cause similar effects. Our business is also generally dependent upon our ability to obtain the services of other persons and entities necessary for the development and maintenance of our business. If we fail to obtain the services of any such person or entities upon which we are dependent on satisfactory terms, or we are unable to replace such relationship, we would have to expend additional resources to develop such capabilities ourselves, which could have a material adverse impact on our short-term cash flow and results of operations and our long-term prospects.

We Are In Competition With Companies Much Larger Than Ourselves. Electronic commerce generally and, in particular, the online retail apparel and fashion accessories market, is a new, dynamic, high-growth market and is rapidly changing and intensely competitive. Our competition for customers comes from a variety of sources including:

- o existing land-based, full price retailers, that are using the Internet to expand their channels of distribution;
- o less established online companies;
- o internet sites;
- o traditional direct marketers; and
- o traditional off-price retail stores, which may or may not use the Internet to grow their customer base.

Competition in our industry has intensified, and we expect this trend to continue as the list of our competitors grows. Many of our competitors and potential competitors have longer operating histories, significantly greater resources, greater brand name recognition and more firmly established supply relationships. We believe that the principal competitive factors in our market include:

- o brand recognition;
- o merchandise selection;
- o price;
- o convenience;
- o customer service;
- o order delivery performance; and
- o site features.

There can be no assurance that we will be able to compete successfully against competitors and future competitors, and competitive pressures faced by us could force us to increase expenses and/or decrease our prices at some point in the future.

We Do Not Have Long Term Contracts With Our Vendors And Therefore The Availability Of Merchandise Is At Risk. We do not have any agreements controlling the long-term availability of merchandise or the continuation of particular pricing practices. Our contracts with suppliers typically do not restrict such suppliers from selling products to other buyers. There can be no assurance that our current suppliers will continue to sell products to us on current terms or that we will be able to establish new or otherwise extend current supply relationships to ensure product acquisitions in a timely and efficient manner and on acceptable commercial terms. In addition, in order to entice new vendors to open up relationships with us, we sometimes are required to either make prepayments or agree to shortened payment terms. Our ability to develop and maintain relationships with reputable suppliers and obtain high quality merchandise is critical to our success. If we are unable to develop and maintain relationships with suppliers that would allow us to obtain a sufficient amount and variety of quality merchandise on acceptable commercial terms, our ability to satisfy our customers' needs, and therefore our long-term growth prospects, would be materially adversely affected. See "Risk Factors - Brand Owners Could Establish Procedures to Limit Our Ability to Purchase Products Indirectly."

We Need To Further Establish Brand Name Recognition. We believe that further establishing, maintaining and enhancing our brand is a critical aspect of our efforts to attract and expand our online traffic. The number of Internet sites that offer competing services, many of which already have well established brands in online services or the retail apparel industry generally, increases the importance of establishing and maintaining brand name recognition. Promotion of Bluefly.com will depend largely on our success in providing a high quality online experience supported by a high level of customer service, which cannot be assured. In addition, to attract and retain online users, and to promote and maintain Bluefly.com in response to competitive pressures, we may find it necessary to increase substantially our advertising and marketing expenditures. If we are unable to provide high quality online services or customer support, or

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otherwise fail to promote and maintain Bluefly.com, or if we incur excessive expenses in an attempt to promote and maintain Bluefly.com, our long-term growth prospects, would be materially adversely affected.

There Can Be No Assurance That Our Technology Systems Will Be Able To Handle Increased Traffic; Implementation Of Changes To Web Site. A key element of our strategy is to generate a high volume of traffic on, and use of, Bluefly.com. Accordingly, the satisfactory performance, reliability and availability of Bluefly.com, transaction processing systems and network infrastructure are critical to our reputation and our ability to attract and retain customers, as well as maintain adequate customer service levels. Our revenues will depend on the number of visitors who shop on Bluefly.com and the volume of orders we can handle. Unavailability of our Web site or reduced order fulfillment performance would reduce the volume of goods sold and could also adversely affect consumer perception of our brand name. We may experience periodic system interruptions from time to time. If there is a substantial increase in the volume of traffic on Bluefly.com or the number of orders placed by customers, we will be required to expand and upgrade further our technology, transaction processing systems and network infrastructure. There can be no assurance that we will be able to accurately project the rate or timing of increases, if any, in the use of Bluefly.com or expand and upgrade our systems and infrastructure to accommodate such increases on a timely

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basis. In order to remain competitive, we must continue to enhance and improve the responsiveness, functionality and features of Bluefly.com, which is particularly challenging given the rapid rate at which new technologies, customer preferences and expectations and industry standards and practices are evolving in the online commerce industry. Accordingly, we redesign and enhance various functions on our Web site on a regular basis, and we may experience instability and performance issues as a result of these changes.

We May Be Subject To Higher Return Rates. We recognize that purchases of apparel and fashion accessories over the Internet may be subject to higher return rates than traditional store bought merchandise. We have established a liberal return policy in order to accommodate our customers and overcome any hesitancy they may have with shopping via the Internet. As a result, our reserve for returns and credit card chargebacks for fiscal 2005, 2004 and 2003 has been 37.8%, 36.6% and 37.1%, respectively. If return rates are higher than expected, our business, prospects, financial condition, cash flows and results of operations could be materially adversely affected.

Our Success Is Largely Dependent Upon Our Executive Personnel. We believe our success will depend to a significant extent on the efforts and abilities of our executive personnel. In particular, we rely upon their strategic guidance, their relationships and credibility in the vendor and financial communities and their ability to recruit key operating personnel. Our current employment agreements with our Chief Executive Officer, Chief Financial Officer and Chief Marketing Officer run through March 2007, July 2006 and September 2008 respectively, however there can be no assurance that any of them will not terminate their employment earlier. The loss of the services of any of our executive officers could have a material adverse effect on our credibility in the vendor communities and our ability to recruit new key operating personnel.

Our Success Is Dependent Upon Our Ability To Attract New Key Personnel. Our operations will also depend to a great extent on our ability to attract new key personnel with relevant experience and retain existing key personnel in the future. The market for qualified personnel is extremely competitive. Our failure to attract additional qualified employees could have a material adverse effect on our prospects for long-term growth.

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There Are Inherent Risks Involved In Expanding Our Operations. We may choose to expand our operations by developing new Web sites, promoting new or complementary products or sales formats, expanding the breadth and depth of products and services offered, expanding our market presence through relationships with third parties, adopting non-Internet based channels for distributing our products, or consummating acquisitions or investments. Expansion of our operations in this manner would require significant additional expenses and development, operations and editorial resources and would strain our management, financial and operational resources. For example, we have historically expended significant internal resources in connection with the redesign of our Web site and the implementation of our online strategic alliances. Moreover, in the event that we expand upon our efforts to open brick-and-mortar outlet stores, we will be required to devote significant internal resources and capital to such efforts. There can be no assurance that we would be able to expand our efforts and operations in a cost-effective or timely manner or that any such efforts would increase overall market acceptance. Furthermore, any new business or Web site that is not favorably received by consumer or trade customers could damage our reputation.

We May Be Liable For Infringing The Intellectual Property Rights Of Others. Third parties may assert infringement claims against us. From time to time in the ordinary course of business we have been, and we expect to continue to be, subject to claims alleging infringement of the trademarks and other intellectual property rights of third parties. These claims and any resulting litigation, if it occurs, could subject us to significant liability for damages. In addition, even if we prevail, litigation could be time-consuming and expensive and could result in the diversion of our time and attention. Any claims from third parties may also result in limitations on our ability to use the intellectual property subject to these claims unless we are able to enter into agreements with the third parties making these claims.

We May Be Liable for Product Liability Claims. We sell products manufactured by third parties, some of which may be defective. If any product that we sell were to cause physical injury or injury to property, the injured party or parties could bring claims against us as the retailer of the product. Our insurance coverage may not be adequate to cover every claim that could be asserted. If a successful claim were brought against the Company in excess of our insurance coverage, it could have a material adverse effect on our cash flow and on our reputation with customers. Unsuccessful claims could result in the expenditure of funds and management time and could have a negative impact on our business.

We Cannot Guarantee The Protection Of Our Intellectual Property. Our intellectual property is critical to our success, and we rely on trademark, copyright, domain names and trade secret protection to protect our proprietary rights. Third parties may

infringe or misappropriate our trademarks or other proprietary rights, which could have a material adverse effect on our business, prospects, results of operations or financial condition. While we enter into confidentiality agreements with our employees, consultants and strategic partners and generally control access to and distribution of our proprietary information, the steps we have taken to protect our proprietary rights may not prevent misappropriation. We are pursuing registration of various trademarks, service marks and domain names in the United States and abroad. Effective trademark, copyright and trade secret protection may not be available in every country, and there can be no assurance that the United States or foreign jurisdictions will afford us any protection for our intellectual property. There also can be no assurance that any of our intellectual property rights will not be challenged, invalidated or

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circumvented. In addition, we do not know whether we will be able to defend our proprietary rights since the validity, enforceability and scope of protection of proprietary rights in Internet-related industries is uncertain and still evolving. Moreover, even to the extent that we are successful in defending our rights, we could incur substantial costs in doing so.

**Our Business Could Be Harmed By Consumers' Concerns About The Security Of Transactions Over The Internet.** Concerns over the security of transactions conducted on the Internet and commercial online services, the increase in identity theft and the privacy of users may also inhibit the growth of the Internet and commercial online services, especially as a means of conducting commercial transactions. Moreover, although we have developed systems and processes that are designed to protect consumer information and prevent fraudulent credit card transactions and other security breaches, failure to mitigate such fraud or breaches could have a material adverse effect on our business, prospects, financial condition and results of operations.

**We Face Legal Uncertainties Relating To The Internet In General And To Our Industry In Particular And May Become Subject To Costly Government Regulation.** We are not currently subject to direct regulation by any domestic or foreign governmental agency, other than regulations applicable to businesses generally, and laws or regulations directly applicable to online commerce. However, it is possible that laws and regulations may be adopted that would apply to the Internet and other online services. Furthermore, the growth and development of the market for online commerce may prompt calls for more stringent consumer protection laws that may impose additional burdens on those companies conducting business online. The adoption of any additional laws or regulations may increase our cost of doing business and/or decrease the demand for our products and services and increase our cost of doing business.

The applicability to the Internet of existing laws in various jurisdictions governing issues such as property ownership, sales and other taxes, libel and personal privacy is uncertain and may take years to resolve. Any such new legislation or regulation, the application of laws and regulations from jurisdictions whose laws do not currently apply to our business, or the application of existing laws and regulations to the Internet and online commerce could also increase our cost of doing business. In addition, if we were alleged to have violated federal, state or foreign, civil or criminal law, we could face material liability and damage to our reputation and, even if we successfully defend any such claim, we incur significant costs in connection with such defense.

**We Face Uncertainties Relating To Sales And Other Taxes.** We are not currently required to pay sales or other similar taxes in respect of shipments of goods into states other than Virginia, Ohio, New Jersey and New York. However, state taxation laws and regulations may change in the future, and one or more states may seek to impose sales tax collection obligations on out-of-state companies such as our company that engage in online commerce. In addition, any new operation in states outside Virginia, Ohio, New Jersey and New York could subject shipments into such states to state sales taxes under current or future laws. A successful assertion by one or more states or any foreign country that the sale of merchandise by us is subject to sales or other taxes, could subject us to material liabilities and, to the extent that we pass such costs on to our customers, could decrease our sales.

**Change Of Control Covenant And Liquidation Preference Of Preferred Stock.** We have agreed with the Soros Funds, that for so long as any shares of their Series A, B, C, D or E Preferred Stock are outstanding, we will not take any action to approve or otherwise facilitate any merger, consolidation or change of control, unless provisions have been made for the holders of such Preferred Stock to receive from the acquirer an amount in cash equal to the respective aggregate liquidation preferences of such Preferred Stock. The aggregate liquidation



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preference of such Preferred Stock is equal to the greater of (i) approximately \$48.3 million (plus any accrued and unpaid dividends) and (ii) the amount that the holders of shares of such Preferred Stock would receive if they were to convert such shares into Common Stock immediately prior to liquidation. While the Series F Preferred Stock does not have a change of control covenant, it has an aggregate liquidation preference of \$5,300,000. Accordingly, the aggregate liquidation preference of all outstanding Preferred Stock, including accrued and unpaid preferred dividends at December 31, 2005 of \$18.6 million, is \$72.2 million.

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The Holders Of Our Common Stock May Be Adversely Affected By The Rights Of Holders Of Preferred Stock That May Be Issued In The Future. Our certificate of incorporation and by-laws, as amended, contain certain provisions that may delay, defer or prevent a takeover. Our Board of Directors has the authority to issue up to 15,479,250 additional shares of Preferred Stock, and to determine the price, rights, preferences and restrictions, including voting rights, of those shares, without any further vote or action by the stockholders. Accordingly, our Board of Directors is empowered, without approval of the holders of Common Stock, to issue preferred stock, for any reason and at any time, with such rates of dividends, redemption provisions, liquidation preferences, voting rights, conversion privileges and other characteristics as it may deem necessary or appropriate. The rights of holders of Common Stock will be subject to, and may be adversely affected by, the rights of holders of any preferred stock that may be issued in the future.

We Rely On The Effectiveness Of Our Internal Controls. Section 404 of the Sarbanes-Oxley Act of 2002 requires that we establish and maintain an adequate internal control structure and procedures for financial reporting and assess on an on-going basis the design and operating effectiveness of our internal control structure and procedures for financial reporting. Our independent registered accounting firm may be required in the future to audit the design and operating effectiveness of our internal controls and attest to management's assessment of the design and the effectiveness of our internal controls. It is possible that, as we prepare for this audit, we could discover certain deficiencies in the design and/or operation of our internal controls that could adversely affect our ability to record, process, summarize and report financial data. We have invested and will continue to invest significant resources in this process. Because management's assessment of internal controls has not been required to be reported in the past, we are uncertain as to what impact a conclusion that deficiencies exist in our internal controls over financial reporting would have on the trading price of our common stock.

Forward-Looking Statements and Associated Risks. This Annual Report contains "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements include, without limitation, any statement that may predict, forecast, indicate, or imply future results, performance, or achievements, and may contain the words "believe," "anticipate," "expect," "estimate," "project," "will be," "will continue," "will likely result," or words or phrases of similar meaning. Forward-looking statements involve risks and uncertainties that may cause actual results to differ materially from the forward-looking statements ("Cautionary Statements"). The risks and uncertainties include, but are not limited to those matters addressed herein under "Risk Factors." All subsequent written and oral forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by the Cautionary Statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of their dates. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future

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events or otherwise.

### ITEM 2. PROPERTIES

We lease approximately 26,000 square feet of office space in New York City. The property is in good operating condition. The lease expires in 2010. Our total lease expense for the current office space during 2005 was approximately \$450,000.

### ITEM 3. LEGAL PROCEEDINGS

We currently, and from time to time, are involved in litigation incidental to the conduct of our business. However, we are not party to any lawsuit or proceeding which in the opinion of management is likely to have a material adverse effect on us.

### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matter was submitted to a vote of stockholders of the Company during the fourth quarter of 2005.

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## PART II

### ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

#### MARKET INFORMATION

The Company's common stock, par value \$.01 per share ("Common Stock"), is quoted on The Nasdaq Capital Market and the Boston Stock Exchange. The following table sets forth the high and low bid prices for the Common Stock for the periods indicated, as reported by the Nasdaq Capital Market:

| FISCAL 2005    | HIGH    | LOW     |
|----------------|---------|---------|
| -----          | -----   | -----   |
| First Quarter  | \$ 2.34 | \$ 1.22 |
| Second Quarter | \$ 2.24 | \$ 1.20 |
| Third Quarter  | \$ 1.88 | \$ 1.40 |
| Fourth Quarter | \$ 1.87 | \$ 0.97 |
|                |         |         |
| FISCAL 2004    | HIGH    | LOW     |
| -----          | -----   | -----   |
| First Quarter  | \$ 4.93 | \$ 3.07 |
| Second Quarter | \$ 3.44 | \$ 1.92 |
| Third Quarter  | \$ 2.30 | \$ 1.40 |
| Fourth Quarter | \$ 3.56 | \$ 1.75 |

#### HOLDERS

As of February 17, 2006, there were approximately 107 holders of record of the Common Stock. We believe that there were more than 5,000 beneficial holders of the Common Stock as of such date.

#### DIVIDENDS

We have never declared or paid cash dividends on our Common Stock. In addition, the terms of our credit facility contain restrictions on our ability to declare or pay dividends. We currently intend to retain any future earnings to finance future growth and, therefore, do not anticipate paying any cash dividends in the

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foreseeable future.

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ITEM 6. SELECTED FINANCIAL DATA

The following selected consolidated financial data should be read in conjunction with the consolidated financial statements and the notes thereto and the information contained in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations." Historical results are not necessarily indicative of future results. The selected financial data for the years ended December 31, 2002 and 2001 and at December 31, 2003, 2002 and 2001 are derived from our audited financial statements not included in this report. All data is in thousands, except share data:

|   | YEAR ENDED DECEMBER 31, |            |            |
|---|-------------------------|------------|------------|
|   | 2005                    | 2004       | 2003       |
| Statement of Operations Data:   |                         |            |            |
| Net sales   | \$ 58,811               | \$ 43,799  | \$ 37,928  |
| Cost of sales   | 35,816                  | 27,393     | 26,603     |
| Gross profit  | 22,995                  | 16,406     | 11,325     |
| Selling, marketing and fulfillment expenses   | 19,841                  | 13,903     | 12,061     |
| General and administrative expenses   | 6,299                   | 6,408      | 5,207      |
| Total operating expenses  | 26,140                  | 20,311     | 17,268     |
| Operating loss  | (3,145)                 | (3,905)    | (5,943)    |
| Interest (expense)/other income   | (675)                   | 114        | (426)      |
| Net loss  | (3,820)                 | (3,791)    | (6,369)    |
| Basic and diluted loss per share:   | \$ (0.54)               | \$ (0.55)  | \$ (0.88)  |
| Basic and diluted weighted average number of common shares outstanding available to common stockholders | 16,153,020              | 14,586,752 | 11,171,018 |

Balance Sheet Data:

|                                | AS OF DECEMBER 31, |              |          |
|--------------------------------|--------------------|--------------|----------|
|                                | 2005               | 2004         | 2003     |
| Cash and cash equivalents      | 9,408              | \$ 7,938 (1) | \$ 7,721 |
| Inventories, net               | 16,893             | 12,958       | 11,340   |
| Other current assets           | 3,536              | 2,559        | 1,863    |
| Total assets                   | 33,045             | 25,541       | 22,998   |
| Current liabilities            | 11,936             | 9,413        | 8,459    |
| Long term liabilities          | 5,244              | 4,739        | 4,260    |
| Shareholders' equity (deficit) | 15,865             | 11,389       | 10,279   |

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(1) Includes restricted cash of \$1,253

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### ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This discussion and analysis of our financial condition and results of operations contains forward-looking statements that involve risks and uncertainties. We have based these forward-looking statements on our current expectations and projections of future events. However, our actual results could differ materially from those discussed herein as a result of the risks that we face, including but not limited to those risks stated in "Risk Factors," or faulty assumptions on our part. In addition, the following discussion should be read in conjunction with the audited consolidated financial statements and the related notes thereto included elsewhere in this report.

#### OVERVIEW

Bluefly, Inc. is a leading Internet retailer that sells over 350 brands of designer apparel, accessories and home furnishings at discounts of up to 75% off of retail value. We launched our Web site in September 1998. Over the past four years our sales have grown at a compounded annual growth rate of more than 26%, while our gross margin percentage has increased from 30.5% in 2001 to 39.1% in 2005.

The recent increase in our margin and sales is the direct result of a new merchandise strategy that we began to implement in spring 2004. As part of that strategy we are bringing current season merchandise and the latest fashion trends to our customer for great value. While there will be some fluctuation in our gross margin percentage from quarter to quarter as we further develop our merchandising and marketing strategy, we believe that we will be able to maintain margins well above our levels from 2003 and earlier.

Based on our improved merchandise strategy and recent customer research, we believe that there is an opportunity to accelerate the growth of our business while continuing to provide our customers with the great values that they have become accustomed to. In an effort to take advantage of this opportunity, we raised \$7 million of equity financing in June and used approximately \$3.2 million of the proceeds to launch a national advertising campaign, and expect to continue to use the proceeds to fund the advertising campaign for the first half of 2006. This campaign launched in September 2005. In addition, we secured a new \$7.5 million credit facility with Wells Fargo Retail Finance, LLC ("Wells Fargo") in July 2005. This facility is primarily being used to help us obtain the proper merchandising mix to support the anticipated growth in demand from our national advertising campaign.

Our net sales increased over 34% to \$58,811,000 for the year ended December 31, 2005 from \$43,799,000 for the year ended December 31, 2004. Our gross margin increased to 39.1% in 2005 from 37.5% in 2004, 29.9% in 2003 and 32.8% in 2002. Our gross profit increased by more than 40% to \$22,995,000 for the year ended December 31, 2005 from \$16,406,000 for the year ended December 31, 2004. This growth in gross profit was driven by the increase in net sales, and by the increase in gross margins. Our operating loss decreased by over 19%, to \$3,145,000 in 2005, from \$3,905,000 in 2004.

We increased our spending in marketing (excluding staff related costs) by 331% to \$6,250,000 for the full year 2005, from \$1,451,000 for the full year 2004. A large portion of the increased marketing expense was a result of the costs

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associated with our national advertising campaign, which was launched in September 2005. For the first three quarters of 2005, our net sales increased by approximately 21%, 27% and 39%, respectively, as compared to the same periods in 2004. For the fourth quarter of 2005, our net sales increased by approximately 46% to \$21,235,000 from \$14,515,000 in the fourth quarter of 2004. For the fourth quarter of 2005, we had operating income of \$131,000 as compared to operating income of \$140,000 in the fourth quarter of 2004. In general, we intend to market our business more aggressively than we have in previous years. This more aggressive growth strategy will cause our marketing expense as a percentage of revenue to increase in the short-term; however, we believe that it is a prudent investment in our business given that our margin structure and average order size have historically resulted in a relatively high positive contribution to overhead and marketing on a customer's first order.

Our reserve for returns and credit card chargebacks increased to 37.8% of gross sales for the year ended December 31, 2005 compared to 36.6% in 2004. The increase was primarily caused by a shift in our merchandise mix towards certain product categories that historically have generated higher return rates. However, we believe that this increase in return rates has been more than offset by the higher gross margins and average order sizes that have been generated by this shift in merchandise mix.

A portion of our inventory includes merchandise that we either purchased with the intention of holding for the appropriate season or were unable to sell in a prior season and have determined to hold for the next selling season, subject (in some cases)

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to appropriate mark-downs. In recent years we have increased the amount of inventory purchased on a pack and hold basis in order to take advantage of opportunities in the market.

At December 31, 2005, we had an accumulated deficit of \$99,947,000. The net losses and accumulated deficit resulted primarily from the costs associated with developing and marketing our Web site and building our infrastructure, as well as non cash beneficial conversion charges resulting from decreases in the conversion price of our Preferred Stock. In order to expand our business, we intend to invest in sales, marketing, merchandising, operations, information systems, site development and additional personnel to support these activities. Therefore, we may continue to incur substantial operating losses. Although we have experienced revenue growth in recent years, this growth may not be sustainable and therefore should not be considered indicative of future performance.

### CRITICAL ACCOUNTING POLICIES

#### Management Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. The most significant estimates and assumptions relate to the adequacy of the allowances for sales returns, recoverability of inventories, useful lives of property and equipment and the realization of deferred tax assets. Actual amounts could differ significantly from these estimates.

#### Revenue Recognition

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We recognize revenue in accordance with Staff Accounting Bulletin ("SAB") No. 104 "Revenue Recognition". Gross sales consists primarily of revenue from product sales and shipping and handling charges and is net of promotional discounts. Net sales represent gross sales, less provisions for returns, credit card chargebacks, and adjustments for uncollected sales taxes. Revenue is recognized when all the following criteria are met:

- o A customer executes an order.
- o The product price and the shipping and handling fee have been determined.
- o Credit card authorization has occurred and collection is reasonably assured.
- o The product has been shipped and received by the customer.

Shipping and handling billed to customers are classified as revenue in accordance with Financial Accounting Standards Board ("FASB") Task Force's Emerging Issues Task Force ("EITF") No. 00-10, "Accounting for Shipping and Handling Fees and Costs" ("EITF No. 00-10").

### Provision for Returns and Doubtful Accounts

We generally permit returns for any reason within 90 days of the sale. Accordingly, we establish a reserve for estimated future returns and bad debt at the time of shipment based primarily on historical data. We perform credit card authorizations and check the verification of our customers prior to shipment of merchandise. However, our future return and bad debt rates could differ from historical patterns, and, to the extent that these rates increase significantly, it could have a material adverse effect on our business, prospects, cash flows, financial condition and results of operations.

### Inventory Valuation

Inventories, which consist of finished goods, are stated at the lower of cost or market value. Cost is determined by the first-in, first-out ("FIFO") method. We review our inventory levels in order to identify slow-moving merchandise and establish a reserve for such merchandise.

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### Deferred Tax Valuation Allowance

We recognize deferred income tax assets and liabilities on the differences between the financial statement and tax bases of assets and liabilities using enacted statutory rates in effect for the years in which the differences are expected to reverse. The effect on deferred taxes of a change in tax rates is realized in income or loss in the period that included the enactment date. We have assessed the future taxable income and determined that a 100% deferred tax valuation allowance is deemed necessary. In the event that we were to determine that we would be able to realize our deferred tax assets, an adjustment to the deferred tax valuation allowance would increase income in the period such determination is made.

### RESULTS OF OPERATIONS

The following table sets forth our statement of operations data for the years ended December 31st. All data is in thousands except as indicated below:

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|   | 2005       |                        | 2004       |               |
|---|------------|------------------------|------------|---------------|
|   |            | As a % of<br>Net Sales |            | As a<br>Net S |
| Net sales                                   | \$ 58,811  | 100.0%                 | \$ 43,799  | 1             |
| Cost of sales                               | 35,816     | 60.9%                  | 27,393     |               |
| Gross profit                                | 22,995     | 39.1%                  | 16,406     |               |
| Selling, marketing and fulfillment expenses | 19,841     | 33.7%                  | 13,903     |               |
| General and administrative expenses         | 6,299      | 10.7%                  | 6,408      |               |
| Total operating expenses                    | 26,140     | 44.4%                  | 20,311     |               |
| Operating loss                              | (3,145)    | (5.3)%                 | (3,905)    |               |
| Interest (expense) other income             | (675)      | (1.2)%                 | 114        |               |
| Net loss                                    | \$ (3,820) | (6.5)%                 | \$ (3,791) |               |

We also measure and evaluate ourselves against certain other key operational metrics. The following table sets forth our actual results based on these other metrics for the years ended December 31st, as indicated below:

|  | 2005      | 2004      | 2003      |
|--|-----------|-----------|-----------|
| Average Order Size (including shipping & handling) | \$ 220.17 | \$ 188.51 | \$ 174.99 |
| New Customers Added during the Year*               | 148,975   | 127,177   | 124,248   |

\* Based on unique email addresses

FOR THE YEAR ENDED DECEMBER 31, 2005 COMPARED TO THE YEAR ENDED DECEMBER 31, 2004

Net sales: Gross sales for the year ended December 31, 2005 increased by approximately 37% to \$94,586,000 from \$69,032,000 for the year ended December 31, 2004. The provision for returns and credit card chargebacks and other credits was approximately 38% for 2005 and 37% for 2004, resulting in a provision of \$35,775,000 for the year ended December 31, 2005 and \$25,233,000 for the year ended December 31, 2004.

After the necessary provisions for returns, credit card chargebacks and adjustments for uncollected sales taxes, our net sales for the year ended December 31, 2005 were \$58,811,000. This represents an increase of over 34% compared to the year ended December 31, 2004, in which net sales totaled \$43,799,000. The growth in net sales was largely driven by the increase in gross average order size (approximately 17% higher than the full year 2004) and an increase in the number of new customers acquired

(approximately 17% higher than the full year 2004). Shipping and handling revenue (which is included in net sales) increased by 16% to \$3,874,000 for the year ended December 31, 2005, from \$3,353,000 for the year ended December 31,

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2004. Revenue from shipping and handling increased at a lower rate than overall revenue, due to the increase in our average order size.

Cost of sales: Cost of sales consists of the cost of product sold to customers, in-bound and out-bound shipping costs, inventory reserves, commissions and packing materials. Cost of sales for the year ended December 31, 2005 totaled \$35,816,000, resulting in gross margin of approximately 39.1%. Cost of sales for the year ended December 31, 2004 totaled \$27,393,000, resulting in gross margin of 37.5%. The increase in gross margin was driven by our focus on negotiating better prices with vendors as well as our strategy of selling more in-season product, which has more value to our customer and therefore demands higher margins, and the timing of our promotions. As our inventory composition was heavily weighted with newer higher margin product there was less lower margin inventory to negatively effect the margins in the current year.

Gross Profit: As a result of the increases in net sales and gross margin, gross profit increased by over 40%, to \$22,995,000 for the year ended December 31, 2005, from \$16,406,000 for the year ended December 31, 2004.

Selling, marketing and fulfillment expenses: Selling, marketing and fulfillment expenses increased by approximately 42% for the year 2005 compared to the year ended 2004. The selling, marketing and fulfillment expenses were comprised of the following:

|            | Year Ended<br>December 31, 2005 | Year Ended<br>December 31, 2004 | Percentage Difference<br>Increase (Decrease) |
|------------|---------------------------------|---------------------------------|--|
|            | -----                           | -----                           | -----  |
| Marketing  | \$ 6,961,000                    | \$ 2,120,000                    | 228.3%                                       |
| Operating  | 6,925,000                       | 5,848,000                       | 18.4%  |
| Technology | 3,567,000                       | 4,086,000                       | (12.7)%                                      |
| E-Commerce | 2,388,000                       | 1,849,000                       | 29.1%  |
|            | -----                           | -----                           |  |
|            | \$ 19,841,000                   | \$ 13,903,000                   | 42.7%  |

As a percentage of net sales, our selling, marketing and fulfillment expenses increased to 33.7% for the year ended December 31, 2005 from 31.7% for the year ended December 31, 2004. The increase in selling, marketing and fulfillment expenses as a percentage of net sales resulted primarily from costs associated with our national advertising campaign (which was launched in September 2005). The increase was offset partially from economies of scale in our operations and technology expenses, as some of the fixed costs involved in maintaining our Web site and processing orders were allocated over a larger number of orders. One of our goals is to achieve greater economies of scale as our business grows, although there can be no assurance that we will be successful in doing so. We plan to continue to invest in all of these areas in the near term in order to grow our business.

Marketing expenses include expenses related to our national ad campaign, online and print advertising, "sweepstakes" promotions as well as staff related costs. Marketing expenses increased by a higher percentage than revenue as a result of the costs associated with our national marketing campaign. Costs in connection with this campaign are being recorded as the magazines and commercials are being released. For the year ended December 31, 2005, approximately \$3.2 million was expensed in connection with this campaign. As a result we expect marketing expense as a percentage of revenue to increase in the short-term. We believe that this is a prudent investment in our business given that our margin structure and average order size have historically resulted in a relatively high positive contribution to overhead on a customer's first order.

Operating expenses include all costs related to inventory management, fulfillment, customer service, and credit card processing. Operating expenses increased in 2005 by over 18% compared to 2004 as a result of variable costs



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associated with the increased sales volume (e.g., picking and packing orders, processing returns and credit card fees), and was offset by costs associated with our 2004 temporary clearance store, which closed in April 2005. Operating costs as a percentage of sales decreased as a result of economies of scale. Variable expenses related to picking and packing orders increased by 30% to \$1.7 million from \$1.3 million and credit card fees increased by over 29% to \$1.8 million from \$1.4 million. Both expenses remained relatively constant as a percentage of gross sales at 2% for 2005 and 2004.

Technology expenses consist primarily of staff related costs, amortization of capitalized costs and Web site hosting. For the year ended December 31, 2005, technology expenses decreased by approximately 13% compared to the year ended December 31, 2004. This decrease resulted from a decrease in headcount and salary related expenses, a decrease in depreciation expense,

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and a decrease in web hosting expense. These factors were partially offset by an increase in the costs associated with software support. Depreciation expense for the year ended December 31, 2005 was lower than depreciation for the year ended December 31, 2004 due to the fact that costs associated with our current platform as well as certain computer equipment was fully depreciated during 2004.

E-Commerce expenses include expenses related to our photo studio, image processing, third party software and Web site design. For the year ended December 31, 2005, this amount increased by approximately 29% as compared to the year ended December 31, 2004, primarily due to an increase in salary related expenses as well as an increase in expenses associated with third party software, third party analytics services and our increased use of outside models for photo shoots.

General and administrative expenses: General and administrative expenses include merchandising, finance and administrative salaries and related expenses, insurance costs, accounting and legal fees, depreciation and other office related expenses. General and administrative expenses for the year ended December 31, 2005 decreased slightly to \$6,299,000 for the year ended December 2005 as compared to \$6,408,000 for the year ended December 31, 2004. The slight decrease in general and administrative expenses was the result of decreased salary and benefit expenses, offset by an increase in public company expenses, and increases in consulting and accounting fees.

As a percentage of net sales, general and administrative expenses decreased to 10.7% in 2005 from 14.6% in 2004.

Loss from operations: Operating loss decreased by over 19% in 2005, to \$3,145,000 from \$3,905,000 in 2004 as a result of the increase in gross profit.

Interest expense and interest and other income, net: Interest and other income for year ended December 31, 2005 decreased to \$181,000 from \$847,000 for the year ended December 31, 2004. Interest and other income was higher in 2004 primarily because of \$564,000 in non-cash income recognized in 2004 to adjust a liability associated with warrants issued by us to their fair value as of June 17, 2004 (at which time the warrants were re-classified as equity as described in Note 6 to our financial statements), as well as \$169,000 realized in 2004 in connection with the judgment we received in the Breider Moore litigation.

Interest expense for the year ended 2005 totaled \$856,000 compared to \$733,000 for the year ended 2004, and related primarily to fees paid in connection with the Loan Facility and interest expense on Convertible Notes held by Soros.

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FOR THE YEAR ENDED DECEMBER 31, 2004 COMPARED TO THE YEAR ENDED  
DECEMBER 31, 2003

Net sales: Gross sales for the year ended December 31, 2004 increased by approximately 15% to \$69,032,000, from \$60,279,000 for the year ended December 31, 2003. The provision for returns and credit card chargebacks and other credits was approximately 37% for both 2004 and 2003, resulting in a provision of \$25,233,000 for the year ended December 31, 2004 and \$22,351,000 for the year ended December 31, 2003.

After the necessary provisions for returns, credit card chargebacks and adjustments for uncollected sales taxes, our net sales for the year ended December 31, 2004 were \$43,799,000. This represents an increase of approximately 15% compared to the year ended December 31, 2003, in which net sales totaled \$37,928,000. The growth in net sales was largely driven by the increase in gross average order size (approximately 8% higher than the full year 2003) and a slight increase in the number of new customers acquired (approximately 2% higher than the full year 2003). Shipping and handling revenue (which is included in net sales) increased by 14% to \$3,353,000 for the year ended December 31, 2004, from \$2,939,000 for the year ended December 31, 2003.

Cost of sales: Cost of sales for the year ended December 31, 2004 totaled \$27,393,000, resulting in gross margin of approximately 38%. Cost of sales for the year ended December 31, 2003 totaled \$26,603,000, resulting in gross margin of 30%. The increase in gross margin was driven by our focus on negotiating better prices with vendors as well as our strategy of selling more in-season product, which has more value to our customer and therefore demands higher margins. The gross margin in 2003 was impacted negatively by our decision to reduce our product margin during the first three quarters of 2003 on certain merchandise in an effort to reduce prior season inventory levels.

Gross Profit: As a result of the increases in net sales and gross margin, gross profit increased by 45%, to \$16,406,000 for the year ended December 31, 2004, from \$11,325,000 for the year ended December 31, 2003.

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Selling, marketing and fulfillment expenses: Selling, marketing and fulfillment expenses increased by approximately 15% for the year 2004 compared to the year ended 2003. As a percentage of net sales, our selling, marketing and fulfillment expenses remained relatively unchanged at approximately 32% for both 2004 and 2003. The selling, marketing and fulfillment expenses were comprised of the following:

|            | Year Ended<br>December 31, 2004 | Year Ended<br>December 31, 2003 | Percentage Difference<br>increase (decrease) |
|------------|---------------------------------|---------------------------------|--|
|            | -----                           | -----                           | -----  |
| Marketing  | \$ 2,120,000                    | \$ 1,898,000                    | 11.7%  |
| Operating  | 5,848,000                       | 5,223,000                       | 12.0%  |
| Technology | 4,086,000                       | 3,420,000                       | 19.5%  |
| E-Commerce | 1,849,000                       | 1,520,000                       | 21.6%  |
|            | -----                           | -----                           |  |
|            | \$ 13,903,000                   | \$ 12,061,000                   | 15.3%  |

The increase in marketing expenses of approximately 12% was primarily driven by the donation of the net proceeds from the sale of "hope." collection products to St. Jude Children's Research Hospital ("St. Jude"). Pursuant to a charitable program with St. Jude, we were the exclusive retailer of the "hope." t-shirt and agreed to donate the net proceeds (i.e., the revenue less the cost of goods sold and the costs of processing and filling the orders) from the sale of all "hope." collection products on our Web site to St. Jude. For the year ended December 31,

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2004, approximately \$141,000 was donated and was recorded as a marketing expense in our financial statements. A portion of the increase also resulted from increased consulting expenses, which were offset slightly by a decrease in staff related expenses.

Operating expenses increased in 2004 by approximately 12% compared to 2003 as a result of variable costs associated with the increased sales volume (e.g., picking and packing orders, processing returns and credit card fees) as well as the overhead costs associated with the store. Variable expenses related to picking and packing orders remained relatively unchanged at \$1.3 million for 2004 and 2003 and credit card fees increased by over 16% to \$1.4 million from \$1.2 million. Both expenses remained constant as a percentage of gross sales at 2% for 2004 and 2003.

For the year ended December 31, 2004, technology expenses increased by approximately 20% compared to the year ended December 31, 2003. This increase was related to an increase in headcount, overall web hosting costs and consulting costs and was slightly offset by a decrease in depreciation expense. The department employed an average of 18 people per month in 2004 compared to 12 people per month in 2003.

For the year ended December 31, 2004, E-commerce expenses increased by approximately 22% as compared to the year ended December 31, 2003. This increase is to the result of an increase in staff related costs, temporary help and the purchase of licenses for new search functionality and Web site analytics.

General and administrative expenses: General and administrative expenses for the year ended December 31, 2004 increased by approximately 23% to \$6,408,000 as compared to \$5,207,000 for the year ended December 31, 2003. As a percentage of net sales, general and administrative expenses increased to 14.6% in 2004 from 13.8% in 2003. The increase in general and administrative expenses was the result of increased salary and benefit expenses of approximately 45% (including \$325,000 of expenses incurred in connection with the Separation Agreement that we entered into with our former CEO) as well as an increase in public company fees. These increases were slightly offset by a reduction in consulting and professional fees.

Loss from operations: Operating loss decreased by approximately 34% in 2004, to \$3,905,000 from \$5,943,000 in 2003 as a result of the increase in gross profit.

Interest expense and Interest and other income, net: Interest and other income for year ended December 31, 2004 increased to \$847,000 from \$38,000 for the year ended December 31, 2003. The increase resulted from \$564,000 recognized to adjust a liability associated with warrants issued by us to their fair value as of June 17, 2004 (at which time the warrants were re-classified as equity as described in Note 6 to our financial statements), the \$169,000 realized in connection with the judgment we received in the Breider Moore litigation and an increase in interest income earned on our cash balance.

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Interest expense for the year ended 2004 totaled \$733,000, and related primarily to fees paid in connection with the Loan Facility and interest expense on Convertible Notes held by Soros. Interest expense for the year ended December 31, 2003 totaled \$464,000, and related to fees paid in connection with our Loan Facility as well as amortization of warrants issued in connection with the January 2003 Financing.

### LIQUIDITY AND CAPITAL RESOURCES

#### General

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At December 31, 2005, we had approximately \$9.4 million in the form of cash and cash equivalents. Working capital at December 31, 2005 and 2004 was \$17.9 million and \$12.8 million, respectively (the 2004 amount excludes the approximately \$1.25 million of restricted cash that we regained access to upon refinancing the Rosenthal Facility). In addition, as of December 31, 2005, we had approximately \$2.9 million committed under the Credit Facility, leaving approximately \$3.75 million of availability, compared to availability of \$1.2 million at December 31, 2004.

In June 2005 we completed a private placement (the "New Financing") pursuant to which we raised \$7,075,431 through the sale of 7,000 shares of newly designated Series F Preferred Stock for an aggregate purchase price of \$7,000,000 and warrants to purchase an additional 603,448 shares of our common stock at an exercise price of \$2.87 per share. The purchase price for the warrants was \$75,431, or \$0.125 per warrant.

In February 2006, Soros agreed to extend the maturity dates on the Convertible Promissory Notes issued to Soros in July and October 2003. The maturity dates of the Notes, which were originally January and April 2004, respectively, were each extended for one year, from May 1, 2006 to May 1, 2007.

We fund our operations through cash on hand, operating cash flow, as well as the proceeds of any equity or debt financing. Operating cash flow is affected by revenue and gross margin levels, as well as return rates, and any deterioration in our performance on these financial measures would have a negative impact on our liquidity. Total availability under the Credit Facility is based primarily upon our inventory levels. In addition, both availability under the Credit Facility and our operating cash flows are affected by the payment terms that we receive from suppliers and service providers, and the extent to which suppliers require us to request Wells Fargo to provide credit support under the Credit Facility. We believe that our suppliers' decision-making with respect to payment terms and/or the type of credit support requested is largely driven by their perception of our credit rating, which is affected by information reported in the industry and financial press and elsewhere as to our financial strength. Accordingly, negative perceptions as to our financial strength could have a negative impact on our liquidity. In addition, newer vendors generally do not provide us with payment terms that are as favorable as those we get from existing relationships and, in some instances, new vendors may require prepayments. During 2005, we have increased our prepayments in order to open up new relationships and gain access to inventory that was not previously available to us. As of December 31, 2005, we had approximately \$485,000 of prepaid inventory on our balance sheet.

In addition, our inventory levels as of December 31, 2005 were approximately \$3.9 million higher than at December 31, 2004. The increase in inventory generally reflects a ramp up in connection with our sales growth as well as opportunistic buying of fresh inventory that has not previously been available to us. However, the increased inventory level could adversely affect our flexibility in taking advantage of other buying opportunities that may become available in the near term.

We believe that our current funds, together with working capital, will be sufficient to enable us to meet our planned expenditures through at least December 31, 2006. We may seek additional equity or debt financings to maximize the growth of our business or if anticipated operating results are not achieved. If such financings are not available on terms acceptable to us, and/or we do not achieve our sales plan, future operations may need to be modified, scaled back or discontinued.

Credit Facility

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In July 2005, we entered into a new three year revolving credit facility with Wells Fargo Retail Finance, LLC ("Wells Fargo"). Pursuant to the Credit Facility, Wells Fargo provides the Company with a revolving loan and issues letters of credit in favor of suppliers or factors. The Credit Facility is secured by a lien on all of the Company's assets, as well as a \$2,000,000 letter of credit issued by Soros in favor of Wells Fargo (the "Soros LC"). Availability under the Credit Facility is determined by a formula that takes into account the amount of the Company's inventory and accounts receivable, as well as the Soros LC.

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The maximum availability is currently \$7,500,000, but can be increased to \$12,500,000 at the Company's request, subject to certain conditions. As of December 31, 2005, total availability under the Credit Facility, after giving effect to the required \$850,000 availability reserve, was approximately \$6,650,000 of which \$2,900,000 was committed, leaving approximately \$3,750,000 available for further borrowings.

Interest accrues monthly on the average daily amount outstanding under the Credit Facility during the preceding month at a per annum rate equal to the prime rate plus 0.75% or LIBOR plus 2.75%. We also pay a monthly commitment fee on the unused portion of the facility (i.e., \$7,500,000 less the amount of loans outstanding) equal to 0.35%. We also pay Wells Fargo certain fees to open letters of credit and guarantees in an amount equal to a certain specified percentage of the face amount of the letter of credit for each thirty (30) days such letter of credit, or a portion thereof, remains open.

Subject to certain conditions, if we default on any of our obligations under the Credit Facility, Wells Fargo has the right to draw upon the Soros LC to satisfy any such obligations. If Wells Fargo draws on the Soros LC, pursuant to the terms of a reimbursement agreement between us and Soros, we would have the obligation to, among other things, reimburse Soros for any amounts drawn under the Soros LC plus interest accrued thereon. In addition, we are required to pay Soros Fund Management LLC an annual fee in connection with the issuance and maintenance of the Soros LC in an amount equal to the fee that we would be required to pay in order to have a similar letter of credit issued under the Credit Facility. For the year beginning on the date of the closing of the Credit Facility this formula requires an annual fee of \$55,000. We are also required to reimburse Soros for any costs and expenses associated with the issuance and maintenance of the Soros LC. In connection with the Soros LC we granted the Soros Fund a subordinated lien on substantially all of our assets, including our cash balances, in order to secure our reimbursement obligations. If we default under the loan facility, our lender and/or the Soros Fund would be entitled, among other things, to foreclose on our assets in order to satisfy our obligations under the loan facility.

Under the terms of the Credit Facility, Soros has the right to purchase all of our obligations from Wells Fargo at any time if we are then in default under the Credit Facility.

### Commitments and Long Term Obligations

As of December 31, 2005, we had the following commitments and long term obligations:

|       |                     |            |
|-------|---------------------|------------|
| Total | Less Than<br>1 year | 1-<br>year |
|-------|---------------------|------------|

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|   |               |            |      |
|---|---------------|------------|------|
| Marketing and Advertising                                 | \$ 1,350,000  | 1,350,000  |      |
| Purchase Orders   | \$ 6,185,000  | 6,185,000  |      |
| Operating Leases  | \$ 1,905,000  | 507,000    | 1,25 |
| Capital Leases  | \$ 67,000     | 40,000     | 2    |
| Employment Contracts                                      | \$ 3,189,000  | 1,671,000  | 1,51 |
| Notes payable to shareholders, including interest payable | \$ 5,217,000  | 5,217,000  |      |
| Grand total   | \$ 17,913,000 | 14,970,000 | 2,8  |

We believe that in order to grow the business, we will need to make additional marketing and advertising commitments in the future. In addition, we expect to hire and train additional employees for the operations and development of Bluefly.com. However, our marketing budget and our ability to hire such employees is subject to a number of factors, including our results of operations as well as the amount of additional capital that we raise.

Off Balance Sheet Arrangements

Certain warrants issued in conjunction with our preferred stock financing are equity linked derivatives and accordingly represent an off balance sheet arrangement. Each of these warrants meet the scope exception in paragraph 11(a) of FAS 133 and are accordingly not accounted for as derivatives for purposes of FAS 133, but instead included as a component of equity. See Footnote 9 to the financial statements and the Statement of Shareholders' Equity for more information.

RECENT ACCOUNTING PRONOUNCEMENTS

In May 2005 the FASB issued SFAS No. 154 "Accounting Changes and Error Corrections." SFAS No. 154 replaces APB Opinion No. 20 and SFAS No. 3. SFAS No. 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company will adopt this Statement beginning January 1, 2006.

In December 2004, the FASB issued Statement No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123R"), which replaces SFAS 123 and supersedes APB No. 25. Under the new standard, companies will no longer be able to account for stock-based compensation transactions using the intrinsic value method in accordance with APB No. 25. Instead, companies will be

required to account for such transactions using a fair-value method and to recognize the expense in the statements of income. The adoption of SFAS 123R will also require additional accounting related to the income tax effects and additional disclosure regarding the cash flow effects resulting from share-based payment arrangements. SFAS 123R will be effective for annual periods beginning after June 15, 2005 and allows, but does not require, companies to restate prior periods. We are evaluating the impact of adopting SFAS 123R and expect that we will record substantial non-cash stock compensation expenses. The adoption of SFAS 123R is not expected to have a significant effect on our cash flows however the non-cash charges associated therewith are expected to have a significant, adverse effect on our results of operations. Based on the current number of unvested options the effect of adopting SFAS 123R, assuming no change in the assumptions set forth in Notes 2 and 9 of the financial statements, would be approximately \$2.7 million for the year ended December 31, 2006.

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### ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We have assessed our vulnerability to certain market risks, including interest rate risk associated with financial instruments included in cash and cash equivalents and our notes payable. Due to the short-term nature of these investments we have determined that the risks associated with interest rate fluctuations related to these financial instruments do not pose a material risk to us.

### ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

#### (a) Index to the Financial Statements

|   |     |
|---|-----|
| Report of Independent Registered Public Accounting Firm   | F-1 |
| Consolidated Balance Sheets as of December 31, 2005 and 2004  | F-2 |
| Consolidated Statements of Operations for the three years ended December 31, 2005, 2004 and 2003                      | F-3 |
| Consolidated Statements of Changes in Shareholders' Equity for the three years ended December 31, 2005, 2004 and 2003 | F-4 |
| Consolidated Statements of Cash Flows for the three years ended December 31, 2005, 2004 and 2003                      | F-5 |
| Notes to Consolidated Financial Statements  | F-6 |
| Schedule II - Valuation and Qualifying Accounts   | S-1 |

#### REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders  
of Bluefly, Inc.:

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Bluefly, Inc. and its subsidiary at December 31, 2005 and December 31, 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the accompanying index presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

/s/ PricewaterhouseCoopers LLP

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New York, New York  
February 17, 2006

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BLUEFLY, INC.  
CONSOLIDATED BALANCE SHEETS  
DECEMBER 31, 2005 AND 2004  
(dollars rounded to the nearest thousand)

|  | 2005          |       |
|--|---------------|-------|
|  | -----         | ----- |
| <b>ASSETS</b>  |               |       |
| Current assets   |               |       |
| Cash and cash equivalents  | \$ 9,408,000  | \$    |
| Restricted cash  | -             | -     |
| Inventories, net   | 16,893,000    | -     |
| Accounts receivable, net of allowance for doubtful accounts  | 1,717,000     | -     |
| Prepaid expenses and other current assets  | 1,819,000     | -     |
|  | -----         | ----- |
| Total current assets   | 29,837,000    | -     |
| Property and equipment, net  | 2,895,000     | -     |
| Other assets   | 313,000       | -     |
|  | -----         | ----- |
| Total assets   | \$ 33,045,000 | \$    |
|  | =====         | ===== |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |               |       |
| Current liabilities  |               |       |
| Accounts payable   | \$ 5,662,000  | \$    |
| Allowance for Sales Returns  | 3,407,000     | \$    |
| Accrued expenses and other current liabilities   | 1,083,000     | -     |
| Deferred revenue   | 1,784,000     | -     |
|  | -----         | ----- |
| Total current liabilities  | 11,936,000    | -     |
| Notes payable to related party shareholders  | 4,000,000     | -     |
| Long-term interest payable to related party shareholders   | 1,217,000     | -     |
| Long-term obligations under capital lease  | 27,000        | -     |
|  | -----         | ----- |
| Total liabilities  | 17,180,000    | -     |
|  | =====         | ===== |
| Commitments and contingencies (Note 8)   |               |       |
| Shareholders' equity   |               |       |
| Series A Preferred Stock - \$.01 par value; 500,000 shares authorized, 460,000 shares issued and outstanding as of December 31, 2005 and 2004, respectively (liquidation preference: \$9.2 million plus accrued dividends of \$5.9 million)    | 5,000         | -     |
| Series B Preferred Stock - \$.01 par value; 9,000,000 shares authorized, 8,889,414 shares issued and outstanding as of December 31, 2005 and 2004, respectively (liquidation preference: \$30 million plus accrued dividends of \$9.5 million) | 89,000        | -     |
| Series C Preferred Stock - \$.01 par value; 3,500 shares authorized, 1,000 shares issued and outstanding as of December 31, 2005 and 2004, respectively (liquidation preference: \$1 million plus accrued dividends of \$286,000)              | -             | -     |
| Series D Preferred Stock - \$.01 par value; 7,150 shares authorized, 6,313.43 and 7,136.548 shares issued and outstanding as of December 31, 2005 and 2004, respectively (liquidation preference:  | -             | -     |



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|  |               |
|--|---------------|
| \$6.3 million plus accrued dividends of \$2.4 million)   | -             |
| Series E Preferred Stock - \$.01 par value; 1,000 shares authorized, issued and outstanding as of December 31, 2005 and 2004, respectively (liquidation preference: \$1.0 million plus accrued dividends of \$347,000) | -             |
| Series F Preferred Stock - \$.01 par value; 7,000 shares authorized, 5,279,714 issued and outstanding as of December 31, 2005 (liquidation preference: \$5.3 million plus accrued dividends of \$192,000)              | -             |
| Common Stock - \$.01 par value; 92,000,000 shares authorized, 19,059,166 and 15,241,756 shares issued and outstanding as of December 31, 2005 and 2004, respectively   | 191,000       |
| Additional paid-in capital   | 115,527,000   |
| Accumulated deficit  | (99,947,000)  |
|  | -----         |
| Total shareholders' equity   | 15,865,000    |
|  | -----         |
| Total liabilities and shareholders' equity   | \$ 33,045,000 |
|  | =====         |

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

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BLUEFLY, INC.  
CONSOLIDATED STATEMENTS OF OPERATIONS  
YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003  
(dollars rounded to the nearest thousand)

|  | 2005           | 2004           | 2003           |
|--|----------------|----------------|----------------|
|  | -----          | -----          | -----          |
| Net sales  | \$ 58,811,000  | \$ 43,799,000  | \$ 37,000,000  |
| Cost of sales  | 35,816,000     | 27,393,000     | 26,000,000     |
|  | -----          | -----          | -----          |
| Gross profit   | 22,995,000     | 16,406,000     | 11,000,000     |
| Selling, marketing and fulfillment expenses  | 19,841,000     | 13,903,000     | 12,000,000     |
| General and administrative expenses  | 6,299,000      | 6,408,000      | 5,000,000      |
|  | -----          | -----          | -----          |
| Total operating expenses   | 26,140,000     | 20,311,000     | 17,000,000     |
|  | -----          | -----          | -----          |
| Operating loss   | (3,145,000)    | (3,905,000)    | (5,000,000)    |
| Interest expense   | (856,000)      | (733,000)      | (1,000,000)    |
| Interest income  | 181,000        | 114,000        | 0              |
| Other income (Note 6)  | -              | 733,000        | 0              |
|  | -----          | -----          | -----          |
| Net loss   | (3,820,000)    | (3,791,000)    | (6,000,000)    |
|  | -----          | -----          | -----          |
| Preferred stock dividends  | (4,958,000)    | (4,275,000)    | (3,000,000)    |
| Deemed dividend related to beneficial conversion feature on Series C Preferred Stock | -              | -              | 0              |
|  | -----          | -----          | -----          |
| Net loss available to common shareholders  | \$ (8,778,000) | \$ (8,066,000) | \$ (9,000,000) |
|  | =====          | =====          | =====          |

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|   |       |            |       |            |       |
|---|-------|------------|-------|------------|-------|
| Basic and diluted loss per common share   | \$    | (0.54)     | \$    | (0.55)     | \$    |
|   | ===== |            | ===== |            | ===== |
| Weighted average number of shares outstanding used in calculating basic and diluted loss per common share |       | 16,153,020 |       | 14,586,752 | 11,   |
|   |       | =====      |       | =====      | ===== |

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

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BLUEFLY, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003

(Dollars rounded to the nearest thousand)

|  | SERIES A<br>PREFERRED STOCK<br>\$.01 PAR VALUE |        | SERIES B<br>PREFERRED STOCK<br>\$.01 PAR VALUE |        | SERIES C<br>PREFERRED STOCK<br>\$.01 PAR VALUE |
|--|--|--------|--|--------|--|
|  | NUMBER OF<br>SHARES                            | AMOUNT | NUMBER OF<br>SHARES                            | AMOUNT | NUMBER OF<br>SHARES                            |
| BALANCE AT JANUARY 1, 2003   | 500,000  | 5,000  | 8,910,782                                      | 89,000 | 1,000  |
| Sale of Series D Preferred Stock<br>(\$1,000 per share)                                    | -  | -      | -  | -      | -  |
| Exchange of note for Series D Preferred<br>Stock (\$1,000 per share)                       | -  | -      | -  | -      | -  |
| Conversion of January 2003 Note to<br>Series D Preferred Stock                             | -  | -      | -  | -      | -  |
| Sale of Series E Preferred Stock<br>(\$1,000 per share)                                    | -  | -      | -  | -      | -  |
| Deemed dividend related to beneficial<br>conversion feature on Series C<br>Preferred Stock | -  | -      | -  | -      | -  |
| Exercise of Employee Stock Options<br>and Warrants   | -  | -      | -  | -      | -  |
| Conversion of Series 2002 Preferred Stock<br>to Series D Preferred Stock                   | -  | -      | -  | -      | -  |
| Conversion of Series A Preferred Stock<br>Series B Preferred Stock to Common Stock         | (40,000)                                       | -      | (21,368)                                       | -      | -  |
| Issuance of warrants to supplier   | -  | -      | -  | -      | -  |
| Issuance of warrants to shareholders   | -  | -      | -  | -      | -  |
| Issuance of warrants in exchange<br>for obligations  | -  | -      | -  | -      | -  |

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|  |         |          |           |           |       |
|--|---------|----------|-----------|-----------|-------|
| Net loss   | -       | -        | -         | -         | -     |
| BALANCE AT DECEMBER 31, 2003   | 460,000 | 5,000    | 8,889,414 | 89,000    | 1,000 |
| Sale of Common Stock and Warrants in connection with the January 2004 financing (net of issuance costs of \$423,000) | -       | -        | -         | -         | -     |
| Change in Value of Warrants  | -       | -        | -         | -         | -     |
| Exercise of Employee Stock Options   | -       | -        | -         | -         | -     |
| Expense recognized in connection with Issuance of Options  | -       | -        | -         | -         | -     |
| Net loss   | -       | -        | -         | -         | -     |
| BALANCE AT DECEMBER 31, 2004   | 460,000 | \$ 5,000 | 8,889,414 | \$ 89,000 | 1,000 |
| Sale of Series F Preferred Stock (\$1,000 per share net of expenses of \$249,000)                                    | -       | -        | -         | -         | -     |
| Shares Of Series D Preferred Stock Converted into Common Stock   | -       | -        | -         | -         | -     |
| Shares Of Series F Preferred Stock Converted into Common Stock   | -       | -        | -         | -         | -     |
| Expense recognized in connection with Issuance of Options  | -       | -        | -         | -         | -     |
| Exercise of Employee Options   | -       | -        | -         | -         | -     |
| Net Loss   | -       | -        | -         | -         | -     |
| BALANCE AT DECEMBER 31, 2005   | 460,000 | 5,000    | 8,889,414 | 89,000    | 1,000 |

|   | SERIES E<br>PREFERRED STOCK<br>\$.01 PAR VALUE |        | SERIES F<br>PREFERRED STOCK<br>\$.01 PAR VALUE |        | SERIES 2002<br>PREFERRED STOCK<br>\$.01 PAR VALUE |        |
|---|--|--------|--|--------|---|--------|
|   | NUMBER OF<br>SHARES                            | AMOUNT | NUMBER OF<br>SHARES                            | AMOUNT | NUMBER OF<br>SHARES                               | AMOUNT |
| BALANCE AT JANUARY 1, 2003  | -  | -      | -  | -      | 2,100   | -      |
| Sale of Series D Preferred Stock (\$1,000 per share)              | -  | -      | -  | -      | -   | -      |
| Exchange of note for Series D Preferred Stock (\$1,000 per share) | -  | -      | -  | -      | -   | -      |
| Conversion of January 2003 Note to Series D Preferred Stock       | -  | -      | -  | -      | -   | -      |
| Sale of Series E Preferred Stock                                  | -  | -      | -  | -      | -   | -      |

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|  |       |      |         |      |         |
|--|-------|------|---------|------|---------|
| (\$1,000 per share)  | 1,000 | -    | -       | -    | -       |
| Deemed dividend related to beneficial conversion feature on Series C Preferred Stock                                 | -     | -    | -       | -    | -       |
| Exercise of Employee Stock Options and Warrants  | -     | -    | -       | -    | -       |
| Conversion of Series 2002 Preferred Stock to Series D Preferred Stock  | -     | -    | -       | -    | (2,100) |
| Conversion of Series A Preferred Stock Series B Preferred Stock to Common Stock                                      | -     | -    | -       | -    | -       |
| Issuance of warrants to supplier   | -     | -    | -       | -    | -       |
| Issuance of warrants to shareholders   | -     | -    | -       | -    | -       |
| Issuance of warrants in exchange for obligations   | -     | -    | -       | -    | -       |
| Net loss   | -     | -    | -       | -    | -       |
| BALANCE AT DECEMBER 31, 2003   | 1,000 | -    | -       | -    | -       |
| Sale of Common Stock and Warrants in connection with the January 2004 financing (net of issuance costs of \$423,000) | -     | -    | -       | -    | -       |
| Change in Value of Warrants  | -     | -    | -       | -    | -       |
| Exercise of Employee Stock Options   | -     | -    | -       | -    | -       |
| Expense recognized in connection with Issuance of Options  | -     | -    | -       | -    | -       |
| Net loss   | -     | -    | -       | -    | -       |
| BALANCE AT DECEMBER 31, 2004   | 1,000 | \$ - | -       | \$ - | -       |
| Sale of Series F Preferred Stock (\$1,000 per share net of expenses of \$249,000)                                    | -     | -    | 7,000   | -    | -       |
| Shares Of Series D Preferred Stock Converted into Common Stock   | -     | -    | -       | -    | -       |
| Shares Of Series F Preferred Stock Converted into Common Stock   | -     | -    | (1,720) | \$ - | -       |
| Expense recognized in connection with Issuance of Options  | -     | -    | -       | -    | -       |
| Exercise of Employee Options   | -     | -    | -       | -    | -       |
| Net Loss   | -     | -    | -       | -    | -       |
| BALANCE AT DECEMBER 31, 2005   | 1,000 | -    | 5,280   | -    | -       |

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|   | COMMON STOCK<br>\$.01 PAR VALUE |            | ADDITIONAL<br>PAID-IN<br>CAPITAL | ACCUMULATED<br>DEFICIT |
|---|---------------------------------|------------|----------------------------------|------------------------|
|   | NUMBER OF<br>SHARES             | AMOUNT     |                                  |                        |
| BALANCE AT JANUARY 1, 2003  | 10,391,904                      | 104,000    | 92,628,000                       | (85,742,000)           |
| Sale of Series D Preferred Stock<br>(\$1,000 per share)   | -                               | -          | 2,000,000                        | -                      |
| Exchange of note for Series D Preferred<br>Stock (\$1,000 per share)  | -                               | -          | 2,027,000                        | -                      |
| Conversion of January 2003 Note to<br>Series D Preferred Stock  | -                               | -          | 1,009,000                        | -                      |
| Sale of Series E Preferred Stock<br>(\$1,000 per share)   | -                               | -          | 1,000,000                        | -                      |
| Deemed dividend related to beneficial<br>conversion feature on Series C<br>Preferred Stock                                    | -                               | -          | 225,000                          | (225,000)              |
| Exercise of Employee Stock Options<br>and Warrants  | 1,869,598                       | 19,000     | 2,947,000                        | -                      |
| Conversion of Series 2002 Preferred Stock<br>to Series D Preferred Stock  | -                               | -          | -                                | -                      |
| Conversion of Series A Preferred Stock<br>Series B Preferred Stock to Common Stock  | 632,664                         | 6,000      | (6,000)                          | -                      |
| Issuance of warrants to supplier  | -                               | -          | 503,000                          | -                      |
| Issuance of warrants to shareholders  | -                               | -          | 42,000                           | -                      |
| Issuance of warrants in exchange<br>for obligations   | -                               | -          | 17,000                           | -                      |
| Net loss  | -                               | -          | -                                | (6,369,000)            |
| BALANCE AT DECEMBER 31, 2003  | 12,894,166                      | 129,000    | 102,392,000                      | (92,336,000)           |
| Sale of Common Stock and Warrants in<br>connection with the January 2004<br>financing (net of issuance costs<br>of \$423,000) | 1,543,209                       | 15,000     | 4,562,000                        | -                      |
| Change in Value of Warrants   | -                               | -          | (564,000)                        | -                      |
| Exercise of Employee Stock Options  | 804,381                         | 8,000      | 733,000                          | -                      |
| Expense recognized in connection with<br>Issuance of Options  | -                               | -          | 147,000                          | -                      |
| Net loss  | -                               | -          | -                                | (3,791,000)            |
| BALANCE AT DECEMBER 31, 2004  | 15,241,756                      | \$ 152,000 | \$ 107,270,000                   | \$ (96,127,000)        |

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|   |            |            |                |                 |
|---|------------|------------|----------------|-----------------|
| Sale of Series F Preferred Stock<br>(\$1,000 per share net of expenses<br>of \$249,000) | -          | -          | 6,751,000      | -               |
| Shares Of Series D Preferred Stock<br>Converted into Common Stock                       | 1,454,645  | 15,000     | (15,000)       | -               |
| Shares Of Series F Preferred Stock<br>Converted into Common Stock                       | 765,481    | 8,000      | (8,000)        | -               |
| Expense recognized in connection with<br>Issuance of Options                            | -          | -          | 41,000         | -               |
| Exercise of Employee Options  | 1,597,284  | 16,000     | 1,488,000      | -               |
| Net Loss  | -          | -          | -              | (3,820,000)     |
| BALANCE AT DECEMBER 31, 2005  | 19,059,166 | \$ 191,000 | \$ 115,527,000 | \$ (99,947,000) |

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

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BLUEFLY, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003

|   | 2005           | 2004           | 2003           |
|---|----------------|----------------|----------------|
| CASH FLOWS FROM OPERATING ACTIVITIES  |                |                |                |
| Net loss  | \$ (3,820,000) | \$ (3,791,000) | \$ (6,360,000) |
| Adjustments to reconcile net loss to net cash used in<br>operating activities |                |                |                |
| Depreciation and amortization   | 1,259,000      | 1,342,000      | 1,740,000      |
| Loss on disposal of assets  | -              | 35,000         | -              |
| Non-cash expense related to warrants issued to supplier                       | 347,000        | 264,000        | -              |
| Change in value of warrants   | -              | (564,000)      | -              |
| Provision for returns   | 1,233,000      | (354,000)      | 80,000         |
| Allowance for doubtful accounts   | 270,000        | 237,000        | 13,000         |
| Reserve for inventory obsolescence  | 659,000        | 100,000        | 48,000         |
| Stock option expense  | 41,000         | 147,000        | -              |
| Changes in operating assets and liabilities                                   |                |                |                |
| (Increase) decrease in  |                |                |                |
| Inventories   | (4,941,000)    | (1,982,000)    | (95,000)       |
| Accounts receivable   | (778,000)      | (289,000)      | (45,000)       |
| Other current assets  | 554,000        | (269,000)      | (12,000)       |
| Prepaid expenses  | (1,020,000)    | (127,000)      | (1,000)        |
| Other assets  | (187,000)      | -              | -              |
| (Decrease) increase in:   |                |                |                |
| Accounts payable  | 1,472,000      | 1,068,000      | 6,000          |
| Accrued expenses  | (171,000)      | 186,000        | (12,000)       |
| Short term interest payable to related party<br>shareholders                  | -              | 20,000         | 2,000          |

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|  |              |              |         |
|--|--------------|--------------|---------|
| Deferred revenue   | 87,000       | 445,000      | 36      |
| Long-term interest payable to related party shareholders                             | 559,000      | 499,000      | 15      |
|  | -----        | -----        | -----   |
| Net cash used in operating activities  | (4,436,000)  | (3,033,000)  | (4,25   |
|  | -----        | -----        | -----   |
| CASH FLOWS FROM INVESTING ACTIVITIES   |              |              |         |
| Cash collateral in connection with Rosenthal Pledge Agreement                        | 1,250,000    | (1,250,000)  |         |
| Purchase of property and equipment   | (2,194,000)  | (1,486,000)  | (48     |
|  | -----        | -----        | -----   |
| Net cash used in investing activities  | (944,000)    | (2,736,000)  | (48     |
|  | -----        | -----        | -----   |
| CASH FLOWS FROM FINANCING ACTIVITIES   |              |              |         |
| Net proceeds from June 2005 financing  | 6,751,000    | -            |         |
| Net proceeds from January 2004 financing   | -            | 4,577,000    |         |
| Net proceeds from exercise of Stock Options  | 1,504,000    | 741,000      | 2,96    |
| Payments of capital lease obligation   | (152,000)    | (349,000)    | (25     |
| Repayment of related party notes   | -            | (236,000)    |         |
| Proceeds from issuance of Notes Payable (October 2003 Financing)                     | -            | -            | 2,00    |
| Proceeds from issuance of Notes Payable (July 2003 Financing)                        | -            | -            | 2,00    |
| Proceeds from sale of Series D Preferred Stock                                       | -            | -            | 2,00    |
| Proceeds from issuance of Notes Payable (January 2003 Financing)                     | -            | -            | 1,00    |
| Proceeds from sale of Series E Preferred Stock                                       | -            | -            | 1,00    |
|  | -----        | -----        | -----   |
| Net cash provided by financing activities  | 8,103,000    | 4,733,000    | 10,70   |
|  | -----        | -----        | -----   |
| Net increase (decrease) in cash and cash equivalents                                 | 2,723,000    | (1,036,000)  | 5,97    |
| CASH AND CASH EQUIVALENTS  |              |              |         |
| Beginning of year  | 6,685,000    | 7,721,000    | 1,74    |
|  | -----        | -----        | -----   |
| End of year  | \$ 9,408,000 | \$ 6,685,000 | \$ 7,72 |
|  | =====        | =====        | =====   |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION                                     |              |              |         |
| Cash paid during the year for interest   | \$ 147,000   | \$ 175,000   | \$ 8    |
| Non-cash investing and financing activities  |              |              |         |
| Equipment acquired under capital lease   | -            | 153,000      | 22      |
| Exchange of note for equity  | -            | -            | 2,02    |
| Conversion of debt to equity   | -            | -            | 1,00    |
| Warrants issued to supplier  | -            | -            | 50      |
| Deemed dividend related to beneficial conversion feature on Series C Preferred Stock | -            | -            | 22      |
| Warrants issued to related party shareholders  | -            | -            | 4       |

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

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BLUEFLY, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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DECEMBER 31, 2005

### 1. THE COMPANY

Bluefly, Inc., a Delaware corporation, (the "Company"), is a leading Internet retailer that sells over 350 brands of designer apparel, accessories and home products at discount prices. The Company's e-commerce Web site ("Bluefly.com" or "Web site") was launched in September 1998.

The Company has sustained net losses and negative cash flows from operations since the formation of Bluefly.com. The Company's ability to meet its obligations in the ordinary course of business is dependent upon its ability to establish profitable operations or raise additional financing through public or private debt or equity financing, or other sources of financing to fund operations. The Company believes that its existing resources, together with working capital should be sufficient to satisfy its cash requirements through December 31, 2006. The Company may seek additional equity or debt financings to maximize the growth of its business or if anticipated operating results are not achieved. If such financings are not available on terms acceptable to the Company, and/or the Company does not achieve its sales plan, future operations will need to be modified, scaled back or discontinued.

### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

#### PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiary. All significant intercompany balances and transactions have been eliminated in consolidation.

#### REVENUE RECOGNITION

The Company recognizes revenue in accordance with Staff Accounting Bulletin ("SAB 101") No. 101 "Revenue Recognition in the Financial Statements," as amended. Gross sales consists primarily of revenue from product sales and shipping and handling charges and is net of promotional discounts. Net sales represent gross sales, less provisions for returns, credit card chargebacks and adjustments for uncollected sales tax. Revenue is recognized when all the following criteria are met:

- o A customer executes an order.
- o The product price and the shipping and handling fee have been determined.
- o Credit card authorization has occurred and collection is reasonably assured.
- o The product has been shipped and received by the customer.

Shipping and handling billed to customers is classified as revenue in accordance with Financial Accounting Standards Board ("FASB") Task Force's Emerging Issues Task Force ("EITF") No. 00-10, "Accounting for Shipping and Handling Fees and Costs" ("EITF No. 00-10").

#### PROVISIONS FOR SALES RETURNS AND DOUBTFUL ACCOUNTS

The Company generally permits returns for any reason within 90 days of the sale. The Company performs credit card authorizations and checks the verifications of its customers prior to shipment of merchandise. Accordingly, the Company establishes a reserve for estimated future sales returns and allowance for doubtful accounts at the time of



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shipment based primarily on historical data.

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BLUEFLY, INC.  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 DECEMBER 31, 2005

Accounts receivable is presented on the consolidated balance sheet net of the allowance for doubtful accounts. As of December 31, 2005 and 2004, the allowance for doubtful accounts was \$78,000 and \$44,000, respectively, and the allowance for sales returns was \$3,407,000 and \$2,174,000, respectively.

Deferred revenue, which consists primarily of goods shipped to customers but not yet received and customer credits, totaled approximately \$1,784,000 and \$1,697,000 as of December 31, 2005 and 2004, respectively.

#### CASH AND CASH EQUIVALENTS

The Company considers all highly liquid investments with an original maturity of three months or less to be cash and cash equivalents.

#### INVENTORIES

Inventories, which consist of finished goods, are stated at the lower of cost or market. Cost is determined by the first-in, first-out ("FIFO") method. The Company reviews its inventory levels in order to identify slow-moving merchandise and establishes a reserve for such merchandise. Inventory reserves are established based on historical data and management's best estimate of excess inventory. Inventory may be marked down below cost if management determines that the inventory stock will not sell at its currently marked price. Inventory is presented net of reserves on the consolidated balance sheet.

As of December 31, 2005 and 2004, inventories, net consists of the following:

|   | 2005          | 2004          |
|---|---------------|---------------|
|   | -----         | -----         |
| Inventory on hand                       | \$ 15,811,000 | \$ 12,433,000 |
| Inventory to be received due to returns | 1,864,000     | 1,360,000     |
| Inventory reserves                      | (782,000)     | (835,000)     |
|   | -----         | -----         |
| Total inventories, net                  | \$ 16,893,000 | \$ 12,958,000 |
|   | =====         | =====         |

#### PROPERTY AND EQUIPMENT

Property and equipment are stated at cost net of depreciation. Equipment and software are depreciated on a straight-line basis over two to seven years. Leasehold improvements are amortized over the shorter of their estimated useful lives or the term of the lease. Lease amortization is included in depreciation expense. Maintenance and repairs are expensed as incurred.

Certain equipment held under capital leases is classified as property and equipment and amortized using the straight-line method over the lease terms and the related obligations are recorded as liabilities.

Costs related to the upgrade and development of the Web Site are accounted for in accordance with EITF Issue No. 00-02 "Accounting for Website Development Costs", and to the extent they are capitalized, are

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amortized over 24 months.

### LONG-LIVED ASSETS

The Company's policy is to evaluate long-lived assets for possible impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable.

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BLUEFLY, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2005

This evaluation is based on a number of factors, including expectations for operating income and undiscounted cash flows that will result from the use of such assets. The Company has not identified any such impairment of assets.

### INCOME TAXES

The Company recognizes deferred income tax assets and liabilities on the differences between the financial statement and tax bases of assets and liabilities using enacted statutory tax rates in effect for the years in which the differences are expected to reverse. The effect on deferred taxes of a change in tax rates is realized in income or loss in the period that includes the enactment date. In addition, valuation allowances are established when it is more likely than not that deferred tax assets will not be realized.

### STOCK BASED COMPENSATION

At December 31, 2005, the Company has three stock-based employee compensation plans, which are described more fully in Note 9. The Company applies Statement of Financial Accounting Standards ("SFAS") No. 148 "Accounting for Stock Based Compensation - Transition and Disclosure, an amendment of FASB Statement No. 123," SFAS No. 123 "Accounting for Stock Based Compensation," and FASB Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation" in accounting for its stock based compensation plan. In accordance with SFAS No. 123, the Company applies Accounting Principles Board Opinion No. 25 and related Interpretations for expense recognition. For the year ended December 31, 2005, and 2004 compensation expense of \$30,000 and \$17,000, respectively, was recorded in connection with certain options issued below market value to the Company's Chief Executive Officer in accordance with the terms of her employment agreement. In addition, for the year ended December 31, 2004, \$113,000 in compensation expense was recorded in connection with certain options issued to the Company's former Chief Executive Officer pursuant to his separation agreement. Except for these options, no compensation expense has been recorded for the year ended December 31, 2005 and December 31, 2004 in connection with stock option grants to employees, because the exercise price of employee stock options equals or exceeds the market price of the underlying stock on the date of grant. Had compensation expense for the Plan been determined consistent with the provisions of SFAS No. 123, the effect on the Company's basic and diluted net loss per share would have been as follows:

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|  | YEAR ENDED DECEMBER 31, |                |                |
|--|-------------------------|----------------|----------------|
|  | 2005                    | 2004           | 2003           |
| Net loss, as reported  | (3,820,000)             | \$ (3,791,000) | \$ (6,369,000) |
| Deduct: total stock-based employee compensation expense determined under fair value based methods for all awards, net of related tax effects | (2,731,000)             | (4,617,000)    | (4,219,000)    |
| Add: Stock-based employee compensation expense included in reported net loss   | 30,000                  | 130,000        | -              |
| Adjusted for Preferred Stock Dividends   | (4,958,000)             | (4,275,000)    | (3,450,000)    |
| Pro forma net loss available to common shareholders  | (11,479,000)            | (12,553,000)   | (14,038,000)   |
| Loss per share   |                         |                |                |
| Basic and diluted, as reported   | \$ (0.54)               | \$ (0.55)      | \$ (0.88)      |
| Basic and diluted, pro forma   | \$ (0.71)               | \$ (0.86)      | \$ (1.26)      |

The effects of applying SFAS No. 123 in this pro forma disclosure are not indicative of future amounts, as additional stock option awards are anticipated in future years.

NET LOSS PER SHARE

The Company calculated net loss per share in accordance with SFAS No. 128, "Earnings Per Share." Basic loss per share excludes dilution and is computed by dividing loss available to common shareholders by the weighted average number of common shares outstanding for the period. For purposes of calculating basic and diluted loss per share, the Company presents the amount of dividends earned but unpaid on the face of the statement of operations.

Diluted loss per share is computed by dividing loss available to common shareholders by the weighted average number of common shares outstanding for the period, adjusted to reflect potentially dilutive securities. Due to the loss, the following shares of Common Stock issuable pursuant to options, warrants, Preferred Stock and Convertible Notes were not included in the computation of diluted earnings per share because the result of such inclusion would be antidilutive:

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|          | COMMON STOCK ISSUABLE |           |           |
|----------|-----------------------|-----------|-----------|
|          | 2005                  | 2004      | 2003      |
| SECURITY |                       |           |           |
| Options  | 8,038,528             | 9,813,379 | 8,508,370 |
| Warrants | 1,883,393             | 1,704,945 | 1,319,144 |

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|                      |                |                |                |
|----------------------|----------------|----------------|----------------|
| Preferred stock      | 44,516,119 (1) | 43,323,430 (1) | 43,323,430 (1) |
| Convertible Notes(2) | -              | -              | -              |

- (1) Excludes dividends on preferred stock, which are payable in cash or common stock, at the Company's option, upon conversion, redemption or liquidation
- (2) Represents debt issued in connection with the July 2003 financing and October 2003 financing, which is convertible into equity securities of the Company sold in any subsequent round of financing, at the holder's option, at a price that is equal to the lowest price per share accepted by any investor in such subsequent round of financing. Until such financing occurs, such debt is not convertible into Common Stock.

### MARKETING EXPENSES

In addition to marketing salaries, marketing expenses consist primarily of online advertising, print and media advertising, costs associated with sweepstakes, direct mail campaigns as well as the related external production costs. The costs associated with online and print advertising are expensed as incurred, while the costs associated with direct mail campaigns are capitalized and charged to expense over the expected future revenue stream. There were no amounts associated with direct mail campaigns capitalized at December 31, 2005 and 2004. Production costs related to print and television are capitalized until they are released. Marketing expenses (excluding marketing and public relations salaries and related salary expenses of \$711,000, \$668,000 and \$628,000) for the years ended December 31, 2005, 2004 and 2003 amounted to approximately \$6,250,000, \$1,452,000 and \$1,270,000, respectively.

### FULFILLMENT EXPENSES

The Company utilizes a third party to perform all of its order fulfillment including warehousing, administrative support, returns processing and receiving labor. For the years ended December 31, 2005, 2004 and 2003, fulfillment expenses totaled \$3,642,000, \$2,914,000 and \$2,776,000, respectively. These amounts are included in selling, marketing and fulfillment expenses in the statement of operations.

### FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amounts of the Company's financial instruments, including cash and cash equivalents, other assets, accounts payable, accrued liabilities, and notes payable to related party shareholders approximate fair value due to their short maturities.

### RECENT ACCOUNTING PRONOUNCEMENTS

In December 2004, the FASB issued Statement No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123R"), which replaces SFAS 123 and supersedes APB No. 25. Under the new standard, companies will no longer be able to account for stock-based compensation transactions using the intrinsic value method in accordance with APB No. 25. Instead, companies will be required to account for such transactions using a fair-value method and to recognize the expense in the statements of income. The adoption of SFAS 123R will also require additional accounting related to the income tax effects and additional disclosure regarding the cash flow effects resulting from share-based payment arrangements. SFAS 123R is effective for periods beginning after June 15, 2005

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and allows, but does not require, companies to restate prior periods. The Company is evaluating the impact of adopting SFAS 123R and expects that it will record substantial non-cash stock compensation expenses. The adoption of SFAS 123R is not expected to have a significant effect on the Company's financial condition or cash flows but is expected to have a significant, adverse effect on its results of operations. Based on the current number of unvested options the effect of adopting SFAS 123R, assuming no change in the assumptions set forth in Note 9, would be approximately \$2.7 million for the year ended December 31, 2006.

In May 2005, the FASB issued Statement No. 154 "Accounting Changes and Error Corrections" ("SFAS No. 154"). This statement replaces APB Opinion No. 20, Accounting Changes, and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements, and changes the requirements for the accounting for and reporting of a change in accounting principle. This Statement applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed. SFAS is effective for periods beginning after December 15, 2005. The adoption of SFAS no. 154 is not expected to have a significant effect on the Company's financial condition, results of operations or cash flows.

### CONCENTRATION

During fiscal 2005, the Company acquired approximately 13.5% of its inventory from one supplier.

### RECLASSIFICATIONS

Certain amounts in the consolidated financial statements of the prior periods have been reclassified to conform to the current period presentation for comparative purposes.

### USE OF ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates and assumptions include the adequacy of the allowances for sales returns, recoverability of inventories, useful lives of property and equipment and the realization of deferred tax assets. Actual results could differ from those estimates.

### 3. PROPERTY AND EQUIPMENT

As of December 31, 2005 and 2004, property and equipment consists of the following:

|                                 | 2005         | 2004         |
|---------------------------------|--------------|--------------|
| Leasehold improvements          | \$ 1,658,000 | \$ 1,065,000 |
| Office equipment                | 574,000      | 483,000      |
| Computer equipment and software | 7,129,000    | 5,619,000    |
|                                 | 9,361,000    | 7,167,000    |

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|                                |              |              |
|--------------------------------|--------------|--------------|
| Less: Accumulated depreciation | (6,466,000)  | (5,234,000)  |
|                                | -----        | -----        |
|                                | \$ 2,895,000 | \$ 1,933,000 |
|                                | =====        | =====        |

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Depreciation and amortization of property and equipment was approximately \$1,145,000, \$1,331,000 and \$1,650,000, for the years ended December 31, 2005, 2004 and 2003, respectively.

4. PREPAID EXPENSES AND OTHER CURRENT ASSETS

As of December 31, 2005 and 2004, prepaid expenses and other current assets consist of the following:

|                      | 2005         | 2004         |
|----------------------|--------------|--------------|
|                      | -----        | -----        |
| Prepaid expenses     | \$ 915,000   | \$ 296,000   |
| Prepaid inventory    | 485,000      | 335,000      |
| Other current assets | 419,000      | 722,000      |
|                      | -----        | -----        |
|                      | \$ 1,819,000 | \$ 1,353,000 |
|                      | =====        | =====        |

5. ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

As of December 31, 2005 and 2004, accrued expenses and other current liabilities consist of the following:

|  | 2005         | 2004         |
|--|--------------|--------------|
|  | -----        | -----        |
| Salary, vacation and bonus accrual         | 574,000      | 721,000      |
| Current portion of capital lease liability | 40,000       | 139,000      |
| Accrued expenses                           | 141,000      | 354,000      |
| Accrued media expenses                     | 328,000      | 138,000      |
|  | -----        | -----        |
|  | \$ 1,083,000 | \$ 1,352,000 |
|  | =====        | =====        |

6. OTHER INCOME

In June 2002, the Company entered into an agreement with a third party investor pursuant to which the investor committed to purchase approximately \$7 million of Common Stock and warrants from the Company. The investor breached the contract by failing to consummate the investment, although it did provide the Company with \$169,000 as a good faith deposit. In October 2002, the Company filed an action against the investor based on its failure to consummate the investment, and in December 2003, the court entered judgment in the Company's favor against the third party investor in the amount of \$3,793,688. In the first quarter of 2004, following the expiration of all applicable appeal periods, the Company recognized the good faith deposit of \$169,000 as other income, as a partial recognition of litigation settlement. Based on the information currently available to it regarding the investor's finances, the Company does not believe that it will be successful in collecting a material amount of additional funds as a result of the

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damages award.

In addition, as discussed in Note 9 below, the Company recognized \$564,000 of other income for the year ended December 31, 2004 to adjust a liability associated with warrants issued by the Company to its fair value as of June 17, 2004 (at which point the liability was reclassified as equity in accordance with EITF 00-19 and described in Note 9).

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### 7. INCOME TAXES

Significant components of the Company's deferred tax assets and liabilities are summarized as follows:

|  | 2005          | 2004          |
|--|---------------|---------------|
| DEFERRED TAX ASSETS                        |               |               |
| Net operating losses                       | \$ 29,252,000 | \$ 27,328,000 |
| Depreciation and amortization              | (137,000)     | (99,000)      |
| Accounts receivable and inventory reserves | 348,000       | 350,000       |
| Accrued vacation                           | 32,000        | -             |
| Accrued bonuses                            | -             | 203,000       |
| Deferred revenue                           | 721,000       | 686,000       |
| Other                                      | 496,000       | 270,000       |
|  | 30,712,000    | 28,738,000    |
| Valuation Allowance                        | (30,712,000)  | (28,738,000)  |
|  |               |               |

The Company is in an accumulated loss position for both financial and income tax reporting purposes. The Company has U.S. Federal net operating loss carryforwards of approximately \$72,388,000 at December 31, 2005 which have expiration dates from 2018 through 2024. Approximately \$6.4 million of these net operating loss carryforwards relate to the exercise of employee stock options and any tax benefit derived there from, when realized, will be accounted for as a credit to additional paid-in-capital rather than a reduction of the income tax provision. Pursuant to Section 382 of the Internal Revenue Code, the usage of these net operating loss carryforwards may be limited due to changes in ownership that have occurred or that may occur in the future. The Company has not yet determined the impact, if any, that changes in ownership have had on net operating loss carryforwards. The Company provided a full valuation allowance on the entire deferred tax asset balance to reflect the uncertainty regarding the realizability of these assets due to operating losses incurred since inception.

The Company's effective tax rate differs from the U.S. Federal Statutory income tax rate of 35% as follows:

|   | 2005     | 2004     | 2003     |
|---|----------|----------|----------|
| Statutory federal income tax rate       | (35.00)% | (35.00)% | (35.00)% |
| State tax benefit, net of federal taxes | (5.41)%  | (5.41)%  | (5.41)%  |

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|   |        |        |        |
|---|--------|--------|--------|
| Other                                     | 0.27%  | 0.34%  | 0.16%  |
| Valuation allowance on deferred tax asset | 40.14% | 40.07% | 40.25% |
|   | -----  | -----  | -----  |
| Effective tax rate                        | 0.00%  | 0.00%  | 0.00%  |
|   | =====  | =====  | =====  |

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8. COMMITMENTS AND CONTINGENCIES

EMPLOYMENT CONTRACTS

The Company has entered into certain employment contracts, which expire through September 2008. As of December 31, 2005, the Company's aggregate commitment for future base salary under these employment contracts is:

|      |              |
|------|--------------|
| 2006 | \$ 1,671,000 |
| 2007 | 1,195,000    |
| 2008 | 323,000      |
|      | -----        |
|      | \$ 3,189,000 |
|      | =====        |

LEASES

The Company leases equipment and space under various capital and operating leases that expire at various dates through 2011. Future minimum lease payments under capital and operating leases, excluding utilities, that have initial or remaining non-cancelable terms in excess of one year are as follows:

|  | CAPITAL<br>LEASES | OPERATING<br>LEASES |
|--|-------------------|---------------------|
|  | -----             | -----               |
| 2006                                       | \$ 40,000         | \$ 507,000          |
| 2007                                       | 27,000            | 481,000             |
| 2008                                       | -                 | 442,000             |
| 2009                                       | -                 | 334,000             |
| Thereafter                                 | -                 | 141,000             |
|  | -----             | -----               |
| Total minimum payments                     | 67,000            | \$ 1,905,000        |
|  | =====             | =====               |
| Obligations due within one year            | (40,000)          |                     |
|  | -----             |                     |
| Long-term obligations under capital leases | \$ 27,000         |                     |
|  | =====             |                     |

Rent expense aggregated approximately \$450,000, \$442,000 and \$427,000 for the years ended December 31, 2005, 2004 and 2003, respectively.

MARKETING COMMITMENTS

As of December 31, 2005, the Company has advertising and marketing commitments in connection with email services, agency fees and costs in connection with a national ad campaign of approximately \$1,350,000 through December 31, 2006.

LEGAL PROCEEDINGS

The Company is, from time to time, involved in litigation incidental to



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the conduct of its business. However, the Company is not party to any lawsuit or proceeding which, in the opinion of management is likely to have a material adverse effect on its financial condition.

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### 9. SHAREHOLDERS' EQUITY

#### AUTHORIZED SHARES

The Company is incorporated in Delaware and has 92,000,000 authorized shares of common stock, \$.01 par value per share ("Common Stock"), and 25,000,000 authorized shares of preferred stock, \$.01 par value per share (the "Preferred Stock"). The Preferred Stock is designated as follows: 500,000 shares of Series A Convertible Preferred Stock (the "Series A Preferred Stock"); 9,000,000 shares of Series B Convertible Preferred Stock (the "Series B Preferred Stock"); 3,500 shares of Series C Convertible Preferred Stock (the "Series C Preferred Stock"); 2,100 shares of Series 2002 Convertible Preferred Stock (the "Series 2002 Convertible Preferred Stock"); 7,150 shares of Series D Convertible Preferred Stock (the "Series D Preferred Stock"); 1,000 shares of Series E Convertible Preferred Stock (the "Series E Preferred Stock"); 7,000 shares of Series F Convertible Preferred Stock (the "Series F Preferred Stock"); and 15,479,250 shares undesignated and available for issuance.

#### PREFERRED STOCK

##### OUTSTANDING SHARES

The Company's currently outstanding shares of Preferred Stock (collectively, the "Outstanding Preferred Stock") include the following: 460,000 shares of Series A Preferred Stock with a stated value of \$9.2 million; 8,889,414 shares of Series B Preferred Stock with a stated value of \$20 million; 1,000 shares of Series C Preferred Stock with a stated value of \$1.0 million; 6,313.43 shares of Series D Preferred Stock with a stated value of approximately \$6.3 million; 1,000 shares of Series E Preferred Stock with a stated value of approximately \$1.0 million and 5,279.714 shares of Series F Preferred Stock with a stated value of approximately \$5.3 million. All of the Series A, B, C, and E, 4,821.090 shares of the D, and 3,000 shares of the F are held by affiliates of Soros Private Equity Partners, LLC ("Soros") that collectively own a majority of the Company's capital stock.

##### LIQUIDATION PREFERENCE

Each share of Outstanding Preferred Stock has a liquidation preference equal to the greater of (i) its stated value plus accrued dividends (and, in the case of the Series B Preferred Stock an additional \$10 million, resulting in an aggregate liquidation preference for all Outstanding Preferred Stock of \$53,600,000 plus accrued dividends of \$18.6 million at December 31, 2005) or (ii) the amount that the holder of such share would receive if it were to convert such share into shares of Common Stock immediately prior to the liquidation, dissolution or winding up of the Company. The liquidation preference and accrued dividends on each series of Preferred Stock at December 31, 2005 is as follows:

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|                          | STATED VALUE  | ACCRUED<br>DIVIDENDS AT<br>DECEMBER 31, 2005 | LIQUIDATION<br>PREFERENCE |
|--------------------------|---------------|--|---------------------------|
|                          | -----         | -----  | -----                     |
| Series A Preferred Stock | \$ 9,200,000  | \$ 5,898,000                                 | \$ 15,098,000             |
| Series B Preferred Stock | 20,800,000    | 9,546,000                                    | 40,346,000 (1)            |
| Series C Preferred Stock | 1,000,000     | 286,000                                      | 1,286,000                 |
| Series D Preferred Stock | 6,300,000     | 2,361,000                                    | 8,661,000                 |
| Series E Preferred Stock | 1,000,000     | 347,000                                      | 1,347,000                 |
| Series F Preferred Stock | 5,300,000     | 192,000                                      | 5,492,000                 |
|                          | -----         | -----  | -----                     |
|                          | \$ 43,600,000 | \$ 18,630,000                                | \$ 72,230,000             |
|                          | =====         | =====  | =====                     |

(1) Includes \$10 million of additional liquidation preference in connection with Series B Preferred Stock

### DIVIDENDS

Each share of Outstanding Preferred Stock bears a cumulative compounding dividend, payable upon conversion in cash or Common Stock, at the Company's option. The Series A Preferred Stock, Series B Preferred Stock and Series C Preferred Stock accrue dividends at the rate of 8% per annum, the Series D Preferred Stock and Series E Preferred Stock accrue dividends at the rate of 12% per annum and the Series F Preferred Stock accrues dividends at the rate of 7%.

### RANKING

All of the shares of Outstanding Preferred Stock rank pari passu with each other, and senior to the Common Stock, with respect to the payment of distributions on liquidation, dissolution or winding up of the Company and with respect to the payment of dividends.

### CONVERSION

The Series A Preferred Stock is convertible into Common Stock at the rate of \$2.34 in stated value per share of Common Stock and The Series F Preferred Stock is convertible into Common Stock at the rate of \$2.32 in stated value per share of Common Stock. The other shares of Outstanding Preferred Stock are convertible into Common Stock at the rate of \$0.76 in stated value per share of Common Stock.

The conversion price of all of the Outstanding Preferred Stock, other than the Series A and F Preferred Stock, is subject to anti-dilution adjustments pursuant to which, subject to certain exceptions, to the extent that the Company issues Common Stock or securities convertible into Common Stock at a price per share less than the conversion price in the future, the conversion price would be decreased so that it would equal the conversion price of the new security or the price at which shares of Common Stock are sold, as the case may be. As more fully described below, the conversion price of the Series B Preferred Stock and the Series C Preferred Stock were reduced from higher levels to \$0.76 upon the issuance of the Series D Preferred Stock as a result of these anti-dilution provisions.

The Series F Preferred Stock contains anti-dilution provisions pursuant to which, subject to certain exceptions, in the event that the Company

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issues or sells its Common Stock or new securities convertible into its Common Stock in the future for less than \$2.32 per share, but for \$1.50 or more per share, the conversion price of the Series F preferred stock would be decreased on a weighted average basis, taking into account the number of new shares issued and the price at which such shares are issued. In the event that the Company issues or sell its Common Stock or new securities convertible into its Common Stock in the future for less than \$1.50 per share, the conversion price

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of the Series F preferred stock would be decreased to the price at which such Common Stock or other new securities are sold. The anti-dilution provisions of the Series F preferred stock are subject to the approval of othe Company's stockholders. The Company expects that approval will be obtained at its next shareholder meeting, as the Soros Funds have agreed to vote all of their shares of the Company's stock (which represent a majority of the votes) in favor of such approval.

### VOTING RIGHTS

All of the shares of Outstanding Preferred Stock vote with the Common Stock on an as-converted basis, and the Company is prohibited from taking certain actions without the approval of a majority of each of the separate classes of Outstanding Preferred Stock (other than the Series F Preferred Stock). In addition, the holders of the Series A Preferred Stock have the right to appoint a designee to the Company's Board of Directors (the "Series A Designee"), and the holders of the Series B Preferred Stock similarly have the right to appoint such a designee (the "Series B Designee"), with both the Series A Designee and the Series B Designee being entitled to seven votes on any issue that comes before the Board of Directors (other than issues relating to the redemption of the Outstanding Preferred Stock, as described below).

### REDEMPTION

The Company is entitled, subject to certain conditions, to redeem the shares of Outstanding Preferred Stock for cash at prices ranging, depending upon the date of such redemption, from 4 times, 4.5 times or 5 times the conversion price. The directors designated by the holders of the Preferred Stock are not entitled to vote on issues relating to the redemption of the Outstanding Preferred Stock (other than the Series F Preferred Stock).

### MISCELLANEOUS RIGHTS

The holders of the Outstanding Preferred Stock have registration rights with respect to the Common Stock issuable upon conversion of the Outstanding Preferred Stock; and the holders of the outstanding Preferred Stock (other than the Series F Preferred Stock) pre-emptive rights with respect to future issuance of capital stock of the Company.

### JUNE 2005 FINANCING

The Company raised over \$7,000,000 in equity financing in June 2005. The financing was effected through a private placement (the "June 2005 Financing") that closed on June 24, 2005. The Company raised \$7,075,431 through the sale of 7,000 shares of newly designated Series F Preferred Stock for an aggregate purchase price of \$7,000,000 and warrants to purchase an additional 603,448 shares of its common stock at an exercise price of \$2.87 per share. The warrants have an expiration date of June

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24, 2008. The aggregate purchase price for the warrants was \$75,431, or \$0.125 per warrant, and all of the warrants were purchased by the New Investors described below. The investors participating in the June 2005 Financing included eight private equity funds that had not previously participated in the Company's financing transactions (the "New Investors"), and two private equity funds affiliated with Soros Fund Management LLC ("Soros") that collectively own a majority of the Company's capital stock. In connection with the June 2005 Financing, the New Investors also purchased from Soros previously issued shares of the Company's Series D Preferred Stock with an aggregate liquidation preference and accrued dividends of \$3,000,000. Both the Series D Preferred Stock and the Series F Preferred Stock are convertible into common stock. The number of shares to be issued upon a conversion is determined by dividing the liquidation preference of the shares of preferred stock to be converted by the conversion price. The conversion price of the Series D Preferred Stock is \$0.76 and the conversion price of the Series F Preferred Stock is \$2.32. As of December 31, 2005, 823.118 shares of Series D Preferred Stock (plus all

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accrued and unpaid dividends payable on such shares) had been converted into 1,454,645 shares of common stock and 1,720.286 shares of Series F Preferred Stock (plus all accrued and unpaid dividends payable on such shares) had been converted into 765,481 shares of common stock, leaving 6,313.43 and 5,279.714 shares of Series D Preferred Stock and Series F Preferred Stock, respectively, issued and outstanding.

### JANUARY 2004 FINANCING

In January 2004, the Company completed a private placement pursuant to which it raised \$5,000,000 (the "January 2004 Financing"). Under the terms of the deal, the Company issued 1,543,209 shares of Common Stock at \$3.24 per share, which was 90% of the trailing five-day average of the Company's volume-weighted stock price as of December 29, 2003, the date that a preliminary agreement was reached as to the pricing of the deal. The Company also issued to the new investors warrants to purchase 385,801 shares of Common Stock at any time during the next five years at an exercise price equal to \$3.96 per share. After professional fees and finders fees paid to brokers, the net proceeds from the transaction were approximately \$4,577,000.

### SOROS FINANCINGS DURING 2003 CONVERSION OF PREFERRED STOCK

In January 2003, the holders of 40,000 shares of the Company's Series A Convertible Preferred Stock and 21,368 shares of the Company's Series B Convertible Preferred Stock exercised their conversion rights with respect thereto. The shares of Series A Convertible Preferred Stock were converted into an aggregate of 341,880 shares of the Company's Common Stock. In addition, as permitted under the Company's Certificate of Incorporation, the Company elected to pay the \$213,216 in accrued and unpaid dividends on such shares of Series A Preferred Stock through the issuance of additional shares of Common Stock at a price per share of \$0.93 (the 30-day trailing average closing price as of the date of conversion). Accordingly, an additional 229,265 shares of the Company's Common Stock were issued as payment in full of the accrued and unpaid dividends on the converted shares of Series A Convertible Preferred Stock, in accordance with the Company's Certificate of Incorporation.

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The shares of Series B Convertible Preferred Stock were converted into an aggregate of 53,765 shares of the Company's Common Stock. In addition, as permitted under the Company's Certificate of Incorporation, the Company elected to pay the \$7,211 in accrued and unpaid dividends on such shares of Series B Preferred Stock through the issuance of additional shares of Common Stock at a price per share of \$0.93 (the 30-day trailing average closing price as of the date of conversion). Accordingly, an additional 7,754 shares of the Company's Common Stock were issued as payment in full of the accrued and unpaid dividends on the converted shares of Series B Convertible Preferred Stock, in accordance with the Company's Certificate of Incorporation.

### JANUARY 2003 FINANCING

In January 2003, the Company issued to Soros \$1 million of demand convertible promissory notes that bore interest at a rate of 8% per annum and had a maturity date of July 28, 2003, and warrants to purchase 25,000 shares of its common stock, exercisable at any time on or prior to January 28, 2007 at \$1.12 per share (the "January 2003 Financing"). Interest on the notes was payable only upon repayment of the principal amount, whether at maturity or upon a mandatory or optional prepayment. The principal amount, together with accrued interest, was convertible into equity securities that the Company might issue in any subsequent round of financing, at the holder's option, at a price that was equal to the lowest price per share accepted by any investor in such subsequent round of financing. These notes were converted into Series D Preferred Stock in connection with the March 2003 Financing described below.

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### MARCH 2003 FINANCING

In March 2003, the Company entered into an agreement with Soros pursuant to which Soros: (i) provided \$2 million of new capital by purchasing 2,000 shares of Series D Preferred Stock, (ii) converted the promissory notes issued to it in the January 2003 Financing and all of its Series 2002 Preferred Stock into 3,109.425 shares of Series D Preferred Stock and (iii) purchased 2,027.123 shares of Series D Preferred Stock, with the proceeds from this sale being retained by Soros as payment in full of the Company's obligations under the Series C Notes (the "March 2003 Financing"). The material terms of the Series D Preferred Stock are described above.

Additionally, Soros agreed to provide the Company with up to \$1 million in additional financing (the "2003 Standby Commitment Amount") on a standby basis at any time prior to January 1, 2004, provided that the Company's cash balances were less than \$1 million at that time (the "2003 Standby Commitment.") Such financing was to be made in one or more tranches as determined by the members of the Company's Board of Directors (other than the Series A Designee and the Series B Designee), and any and all draws against the 2003 Standby Commitment Amount were to be effected through the purchase of newly-designated shares of Series E Preferred Stock. Subject to certain limitations, the 2003 Standby Commitment Amount was to be reduced on a dollar-for-dollar basis by the gross cash proceeds received by the Company or any of its subsidiaries from the issuance of any equity or convertible securities after March 12, 2003.

As a result of the March 2003 Financing, the conversion price of the

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Series B Preferred Stock and the Series C Preferred Stock automatically decreased from \$0.93 to \$0.76 per share. In accordance with EITF 00-27, the reduction in the conversion price of the Series C Preferred Stock resulted in the Company recording a beneficial conversion feature in the approximate amount of \$225,000 as part of its financial results for the first quarter of 2003. This non-cash charge, which is analogous to a dividend, resulted in an adjustment to the Company's computation of Loss Per Share.

### MAY 2003 FINANCING

In accordance with the terms of the 2003 Standby Commitment, in May 2003 Soros invested an additional \$1.0 million in the Company through the purchase of 1,000 shares of Series E Preferred Stock and thereby fulfilled the 2003 Standby Commitment in full. The terms of the Series E Preferred Stock are described above.

### JULY 2003 FINANCING

In July 2003, Soros invested an additional \$2.0 million in the Company. Under the terms of the transaction, the Company issued \$2.0 million of convertible promissory notes that bear interest at a rate of 12% per annum and had a maturity date of January 12, 2004 (which, was subsequently extended to May 1, 2006). Interest on the notes is payable only upon repayment of the principal amount, whether at maturity or upon a mandatory or optional prepayment. The principal amount, together with accrued interest, is convertible into equity securities of the Company sold in any subsequent round of financing, at the holder's option, at a price that is equal to the lowest price per share accepted by any investor in such subsequent round of financing (the "July 2003 Financing"). The conversion of the notes is subject to certain limitations until such time as the conversion provisions are approved by the Company's stockholders.

### OCTOBER 2003 FINANCING

In October 2003 Soros invested an additional \$2.0 million in the Company. Under the terms of the transaction, the Company issued \$2.0 million of convertible promissory notes. These notes were on substantially the same terms as the notes issued in the July 2003 Financing, except that the

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maturity date of these notes was April 14, 2004. Subsequent to year end, the maturity date of these notes was extended to May 1, 2006.

### WARRANTS

#### WARRANTS TO SOROS

The Company has issued warrants to Soros in connection with past and recent financings as well as in connection with the Rosenthal Loan Facility (which has since been refinanced). Warrants issued in connection with the Company's Loan Facility are included in the table below and are described more fully in Note 11 below.

In connection with the January 2003 Financing, the Company issued warrants to purchase 25,000 shares of its common stock, exercisable at any time on or prior to January 28, 2007 at \$1.12 per share to Soros.

The Company valued the warrants using the Black Scholes option pricing

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model using the following assumptions: risk free interest rate: 3.54%, volatility 113%, expected life 4 years, zero dividend yield. Using these factors the warrants were valued at \$21,000 and were expensed over the life of the note. The full amount was expensed in the first quarter of 2003.

In exchange for the March 2002 Standby Agreement, the Company issued to Soros warrants to purchase 100,000 shares of Common Stock at an exercise price of \$1.68 per share (the 20 day trailing average of the closing sale price of the Company's Common Stock on the date of issuance), exercisable at any time until March 27, 2007. The Company valued the warrants using the Black Scholes option pricing model using the following assumptions: risk free interest rate: 5.22%, volatility 183%, expected life 3 years, zero dividend yield. The Company accounted for the warrants by crediting additional paid in capital for approximately \$157,000 and capitalizing the amount on the balance sheet. This amount was then netted against the proceeds from the subsequent May 2003 Financing and July 2003 Financing described above, on a pro rata basis.

### WARRANTS TO SUPPLIER

On December 22, 2003 the Company issued warrants to purchase 250,000 shares of Common Stock at an exercise price of \$2.34 per share to a supplier of inventory in exchange for reduced pricing. The warrants are fully vested and expire on December 22, 2006. The Company valued the warrants using the Black-Scholes option pricing model (key assumptions: risk free interest rate: 3.75%, volatility 85%, expected life 2 years, zero dividend yield). The total value of \$502,500 was capitalized and classified as prepaid inventory. The Company reclassified the prepaid inventory when inventory was purchased as a component of the inventory cost. As of December 31, 2005 and 2004 approximately \$0, and \$251,000, respectively, of this asset remained on the balance sheet and was included in other current assets.

### WARRANTS ISSUED TO INVESTORS

The Company used the Black-Scholes option pricing method (assumption: volatility 79%, risk free rate 3.86% one and a half year expected life and zero dividend yield) to calculate the value of the 603,448 warrants issued in connection with the June 2005 Financing. Using those assumptions a value of approximately \$423,000 was assigned to the warrant. In accordance with EITF 00-27, Application of EITF Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios" the Company evaluated the total value ascribed to the warrants under Black-Scholes and compared that to the total proceeds

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raised. In connection with that the Company recognized a beneficial conversion feature of approximately \$87,000.

In accordance with EITF 00-19, the Company accounted for the 385,801 warrants issued in connection with the January 2004 Financing at fair market value and classified the warrants as a liability because the Company may have been required to make cash payments to the investors who purchased the warrants in the event that the registration statement covering the offer and sale of the shares underlying the warrants were to no longer be effective. The Company used the Black-Scholes option

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pricing method (assumption: volatility 147%, risk free rate 3.76% two year expected life and zero dividend yield) to calculate the value of the warrants. At January 12, 2004, the date of transaction (the "Transaction Date"), the warrants had a value of \$1,096,000. The value of the warrants was marked to market in each subsequent reporting period as a derivative gain or loss until June 17, 2004 (the "End Date"), at which time EITF 00-19 called for the warrants to be re-classified as equity because the maximum potential cash amount payable to the investors had decreased to the point where it was no longer considered significant.

During the period beginning on the Transaction Date and ending on the End Date, the value of the warrants decreased from \$1,096,000 to \$532,000, and, accordingly the Company recognized \$564,000 of other income for the year ended December 31, 2004.

The following table represents warrants issued to purchase Common Stock as of December 31, 2005:

| PARTY     | NUMBER OF<br>WARRANTS       | EXERCISE PRICE RANGE | EXPIRATION DATES          |
|-----------|-----------------------------|----------------------|---------------------------|
| Investors | 989,249                     | \$2.87 - \$3.96      | June 2008 - January 2009  |
| Soros     | 606,644                     | \$0.78 - \$2.34      | January 2007 - March 2013 |
| Supplier  | 250,000                     | \$2.34               | December 2006             |
| Others    | 37,500                      | \$1.34               | March 2006                |
|           | -----<br>1,883,393<br>===== |                      |                           |

### STOCK OPTION PLANS

The Company's Board of Directors has adopted three stock option plans, one in April 2005, one in July 2000 and the other in May 1997 (collectively the "Plans"). The Plans were adopted for the purpose of encouraging key employees, consultants and directors who are not employees to acquire a proprietary interest in the growth and performance of the Company. Options are granted in terms not to exceed ten years and become exercisable as specified when the option is granted. Vesting terms of the options range from immediately to a ratable vesting period of four years. The Plans have an aggregate of 15,700,000 shares authorized for issuance.

The following table summarizes the Company's stock option activity:

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|                              | NUMBER<br>OF<br>SHARES | WEIGHTED<br>AVERAGE<br>EXERCISE<br>PRICE |
|------------------------------|------------------------|--|
| BALANCE AT JANUARY 1, 2003   | 8,508,412              | \$ 2.27                                  |
| Options granted              | 2,561,000              | \$ 1.34                                  |
| Options canceled             | (705,030)              | \$ 3.49                                  |
| Options exercised            | (1,856,012)            | \$ 1.59                                  |
| BALANCE AT DECEMBER 31, 2003 | -----<br>8,508,370     | \$ 2.04                                  |



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|  |             |    |      |
|--|-------------|----|------|
| Options granted                            | 2,629,750   | \$ | 2.74 |
| Options canceled                           | (534,360)   | \$ | 2.57 |
| Options exercised                          | (790,381)   | \$ | 0.95 |
|  | -----       |    |      |
| BALANCE AT DECEMBER 31, 2004               | 9,813,379   | \$ | 2.28 |
|  | -----       |    |      |
| Options granted                            | 2,039,000   | \$ | 1.39 |
| Options canceled                           | (2,216,567) | \$ | 3.56 |
| Options exercised                          | (1,597,284) | \$ | 0.94 |
|  | -----       |    |      |
| BALANCE AT DECEMBER 31, 2005               | 8,038,528   | \$ | 1.97 |
|  | -----       |    |      |
| Eligible for exercise at December 31, 2003 | 4,523,606   | \$ | 1.30 |
| Eligible for exercise at December 31, 2004 | 6,512,125   | \$ | 2.44 |
| Eligible for exercise at December 31, 2005 | 4,969,929   | \$ | 2.15 |

The stock options are exercisable in different periods through 2014. Additional information with respect to the outstanding options as of December 31, 2005, is as follows:

| RANGE OF EXERCISE PRICES | OPTIONS OUTSTANDING |   |                                 | OPTIONS EXERCISABLE |                                 |
|--------------------------|---------------------|---|---------------------------------|---------------------|---------------------------------|
|                          | OPTIONS OUTSTANDING | WEIGHTED AVERAGE REMAINING CONTRACTUAL LIFE | WEIGHTED AVERAGE EXERCISE PRICE | OPTIONS EXERCISABLE | WEIGHTED AVERAGE EXERCISE PRICE |
| \$ 0.00 - \$ 1.66        | 4,975,616           | 8.0 Years                                   | \$ 1.23                         | 3,187,903           | \$                              |
| \$ 1.66 - \$ 3.32        | 2,697,512           | 7.6 Years                                   | \$ 2.32                         | 1,471,055           | \$                              |
| \$ 3.32 - \$ 4.98        | 101,000             | 8.1 Years                                   | \$ 3.92                         | 46,571              | \$                              |
| \$ 4.98 - \$ 6.64        | 22,250              | 3.0 Years                                   | \$ 5.11                         | 22,250              | \$                              |
| \$ 6.64 - \$ 9.96        | 52,750              | 3.6 Years                                   | \$ 9.17                         | 52,750              | \$                              |
| \$ 9.96 - \$11.62        | 104,250             | 4.0 Years                                   | \$ 11.20                        | 104,250             | \$                              |
| \$11.62 - \$14.94        | 6,250               | 3.9 Years                                   | \$ 14.04                        | 6,250               | \$                              |
| \$14.94 - \$16.60        | 78,900              | 3.1 Years                                   | \$ 15.13                        | 78,900              | \$                              |
| \$ 0.69 - \$16.60        | 8,038,528           | 7.6 Years                                   | \$ 1.97                         | 4,969,929           | \$                              |

The Company does not recognize compensation expense for stock options granted to employees and directors with an exercise price at or above fair market value at the date of the grant, in accordance with APB No. 25. The fair value of options granted during 2005, 2004 and 2003 was approximately \$2.5 million, \$6.8 million and \$2.9 million, respectively. The Company calculated the fair value of each option grant on the date of the grant using the Black-Scholes option pricing model as prescribed by SFAS No. 123.

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The following assumptions were used in applying the model:

YEAR ENDED DECEMBER 31,

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|                          | 2005  | 2004  | 2003  |
|--------------------------|-------|-------|-------|
|                          | ----- | ----- | ----- |
| Risk-free interest rates | 4.22% | 3.63% | 3.59% |
| Expected life (in years) | 6     | 6     | 6     |
| Dividend yield           | 0%    | 0%    | 0%    |
| Expected volatility      | 138%  | 139%  | 113%  |

As of December 31, 2005, the Company has reserved an aggregate of 54,438,040 shares of Common Stock for the conversion of Preferred Stock and the exercise of Stock Options and Warrants.

### 10. NOTES PAYABLE TO RELATED PARTY SHAREHOLDERS

In addition to the \$4,000,000 of promissory notes issued in connection with the July 2003 Financing and October 2003 Financing (see Note 9 above), on December 15, 2001, the Company issued promissory notes in the amount of \$182,000 to affiliates of Soros in exchange for legal services provided during the course of the year. The notes bore interest at 9% per annum and had a maturity date of December 15, 2004. In December 2004 the Company repaid the notes with accrued interest of \$54,000 for a total of \$236,000.

In January 2004, the Company also extended the maturity dates on the Convertible Promissory Notes issued to Soros in July and October 2003 (the "Notes"). The maturity dates of the Notes, which were originally January and April 2004, respectively, were each extended to March 1, 2005. In February 2006, the maturity date of the Notes was further extended to May 1, 2007.

### 11. FINANCING AGREEMENT

In July 2005, the Company entered into a new three year revolving credit facility ("Credit Facility") with Wells Fargo Retail Finance, LLC ("Wells Fargo"). The Credit Facility refinanced the Company's previous credit facility (the "Rosenthal Facility") with Rosenthal & Rosenthal, Inc. ("Rosenthal"). Under the terms of the Credit Facility, Wells Fargo provides the Company with a revolving credit facility and issues letters of credit in favor of suppliers or factors. The Credit Facility is secured by a lien on all of the Company's assets, as well as a \$2,000,000 letter of credit issued by Soros in favor of Wells Fargo (the "Soros LC"). Availability under the Credit Facility is determined by a formula that takes into account the amount of the Company's inventory and accounts receivable, as well as the Soros LC. The maximum availability is currently \$7,500,000, but can be increased to \$12,500,000 at the Company's request, subject to certain conditions. As of December 31, 2005, total availability under the Credit Facility, after giving effect to the required \$850,000 availability reserve, was approximately \$6,650,000 of which \$2,900,000 was committed, leaving approximately \$3,750,000 available for further borrowings. As a result of the refinancing of the Rosenthal Facility, the Company also regained access to approximately \$1,250,000 of the cash that had previously been restricted because it was being held as cash collateral by Rosenthal under the terms of the Rosenthal Facility.

Interest accrues monthly on the average daily amount outstanding under the Credit Facility during the preceding month at a per annum rate equal to the prime rate plus 0.75% or LIBOR plus 2.75%.

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The Company also pays a monthly commitment fee on the unused portion of the facility (i.e., \$7,500,000 less the amount of loans outstanding) equal to 0.35%. We also pay Wells Fargo certain fees to open letters of credit and guarantees in an amount equal to a certain percentage of the face amount of the letter of credit for each thirty (30) days such letter of credit, or a portion thereof, remains open. For the years ended December 31, 2005, 2004 and 2003 total interest expense and fees related to the credit facilities totaled approximately \$196,000, \$112,000 and \$77,000, respectively.

Subject to certain conditions, if the Company defaults on any of its obligations under the Credit Facility, Wells Fargo has the right to draw upon the Soros LC to satisfy any such obligations. If Wells draws on the Soros LC, pursuant to the terms of a reimbursement agreement between the Company and Soros, the Company would have the obligation to, among other things, reimburse Soros for any amounts drawn under the Soros LC plus interest accrued thereon. In addition, the Company is required to pay Soros Fund Management LLC an annual fee in connection with the issuance and maintenance of the Soros LC in an amount equal to the fee that we would be required to pay in order to have a similar letter of credit issued under the Credit Facility. For the year beginning on the date of the closing of the Credit Facility this formula requires an annual fee of \$55,000. The Company is also required to reimburse Soros for any costs and expenses associated with the issuance and maintenance of the Soros LC. In connection with the Soros LC we granted the Soros Fund a subordinated lien on substantially all of our assets, including our cash balances, in order to secure our reimbursement obligations. If we default under the loan facility, our lender and/or the Soros Fund would be entitled, among other things, to foreclose on our assets in order to satisfy our obligations under the loan facility.

Under the terms of the Credit Facility, Soros has the right to purchase all of our obligations from Wells Fargo at any time if we are then in default under the Credit Facility.

#### SOROS WARRANTS IN CONNECTION WITH ROSENTHAL LOAN FACILITY

Prior to April 2004, Soros guaranteed repayment of the Rosenthal Loan Facility (the "Soros Guarantee"). The Company issued warrants to Soros in consideration for the establishment and continuance of the Soros Guarantee as described below.

The following table represents the warrants issued to Soros in connection with the Loan Facility:

| NUMBER OF<br>WARRANTS | DATE<br>ISSUED    | EXERCISE<br>PRICE | EXPIRATION DATE       | ASSUMPTIONS UNDER<br>BLACK-SCHOLES                            | -----                      |
|-----------------------|-------------------|-------------------|-----------------------|---|----------------------------|
| 100,000               | March 31,<br>2001 | \$ 0.88 (1)       | September 11,<br>2011 | Risk Free Rate - 4.86%<br>Volatility - 117%<br>Term - 5 years | As co<br>Soro<br>the       |
| 60,000                | March 22,<br>2002 | \$ 1.66 (1)       | March 22, 2007        | Risk Free Rate - 5.25%<br>Volatility - 184%<br>Term - 3 years | In co<br>Soro<br>So<br>unt |

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25,000 March 17, 2003 \$ 0.78(2) March 17, 2013 Risk Free Rate - 3.31%  
Volatility - 123%  
Term - 4 years

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- (1) represents the 20 day trailing average of the closing sale price of the Company's Common Stock on the date of issuance
- (2) represents the 10 day trailing average of the closing sale price of the Company's Common Stock on the date of issuance

The Company accounted for the warrants in accordance with Accounting Principles Board Opinion No. 14 ("APB No. 14") by valuing the warrants using the Black-Scholes option pricing model and crediting additional paid in capital for \$74,000, \$98,000 and \$21,000, during the years 2001, 2002 and 2003, respectively. These amounts were amortized to interest expense over the life of the Loan Facility.

12. QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)

Amounts in thousands, except per share data:

| 2005  | QUARTER ENDED |            |              |             |
|---|---------------|------------|--------------|-------------|
|   | March 31      | June 30    | September 30 | December 31 |
| Net Sales                                   | \$ 13,502     | \$ 12,029  | \$ 12,045    | \$ 12,045   |
| Gross Profit                                | \$ 4,885      | \$ 4,651   | \$ 4,575     | \$ 4,575    |
| Net loss                                    | \$ (893)      | \$ (1,169) | \$ (1,703)   | \$ (1,703)  |
| Preferred stock dividends                   | \$ (1,115)    | \$ (1,169) | \$ (1,387)   | \$ (1,387)  |
| Net loss available to common shareholders   | \$ (2,008)    | \$ (2,338) | \$ (3,090)   | \$ (3,090)  |
| (Loss) per common share - basic and diluted | \$ (0.13)     | \$ (0.15)  | \$ (0.20)    | \$ (0.20)   |

| 2004         | QUARTER ENDED |          |              |             |
|--------------|---------------|----------|--------------|-------------|
|              | March 31      | June 30  | September 30 | December 31 |
| Net Sales    | \$ 11,114     | \$ 9,495 | \$ 8,675     | \$ 8,675    |
| Gross Profit | \$ 3,782      | \$ 3,807 | \$ 2,966     | \$ 2,966    |

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|   |            |            |            |    |
|---|------------|------------|------------|----|
| Net Income (Loss)                           | \$ (1,130) | \$ (708)   | \$ (1,960) | \$ |
| Preferred stock dividends                   | \$ (1,024) | \$ (1,062) | \$ (1,090) | \$ |
| Net loss available to common shareholders   | \$ (2,154) | \$ (1,770) | \$ (3,050) | \$ |
| (Loss) per common share - basic and diluted | \$ (0.15)  | \$ (0.12)  | \$ (0.21)  | \$ |

13. RELATED PARTY TRANSACTIONS

In August 2004, the Company entered into a Separation Agreement with its former Chief Executive Officer in connection with his resignation. Under the terms of the agreement, he agreed to remain employed by the Company in a non-executive capacity through November 30, 2004 (the "Termination Date") at his then-current salary and to extend the period of the non-competition and non-solicitation covenants contained in his employment agreement from one year to two years after

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the Termination Date. In consideration for these agreements, the Company, among other things, agreed to (i) to make salary continuation payments equal to his salary until June 30, 2005, (ii) to continue to provide his then-current employee benefits for a period of one year following the Termination Date, and (iii) to issue him an option to purchase 100,000 shares of Common Stock at an exercise price equal to the fair market value of the Common Stock on the date of grant and (iv) that all outstanding stock options held by him would vest upon the Termination Date. The Company valued the warrants using the Black Scholes option pricing model using the following assumptions: risk free interest rate: 3.88%, volatility 137%, expected life 1 year, zero dividend yield, and charged \$113,000 for the options and \$212,000 related to severance and benefits to general and administrative expense in the third quarter of 2004.

In December 2003, the Company retained a former Executive Vice President of the Company as a consultant. For the year ended December 31, 2004, payments made to the individual were \$58,000.

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SCHEDULE II - VALUATION AND QUALIFYING ACCOUNTS  
 FOR THE THREE YEARS ENDED DECEMBER 31, 2005

| Column A    | Column B                             | Column C                      |                           | Co  |
|-------------|--------------------------------------|-------------------------------|---------------------------|-----|
|             |                                      | (1)                           | (2)                       |     |
| Description | Beginning Balance at January 1, 2005 | Charged to Costs and Expenses | Charged to other Accounts | Ded |

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|                                  |              |              |           |
|----------------------------------|--------------|--------------|-----------|
| Allowance for Sales Returns      | (2,174,000)  | (34,820,000) | -         |
| Allowance for Doubtful Accounts  | (44,000)     | (270,000)    | -         |
| Inventory Reserves               | (835,000)    | (659,000)    | -         |
| Deferred Tax Valuation Allowance | (28,738,000) | (1,533,000)  | (441,000) |

| Column A                         | Column B                             | Column C                      |                           | Co  |
|----------------------------------|--------------------------------------|-------------------------------|---------------------------|-----|
|                                  |                                      | (1)                           | (2)                       |     |
| Description                      | Beginning Balance at January 1, 2004 | Charged to Costs and Expenses | Charged to other Accounts | Ded |
| Allowance for Sales Returns      | (2,528,000)                          | (24,186,000)                  | -                         |     |
| Allowance for Doubtful Accounts  | (40,000)                             | (237,000)                     | -                         |     |
| Inventory Reserves               | (673,000)                            | (100,000)                     | -                         |     |
| Deferred Tax Valuation Allowance | (26,872,000)                         | (1,518,000)                   | (348,000)                 |     |

| Column A                         | Column B                             | Column C                      |                           | Co  |
|----------------------------------|--------------------------------------|-------------------------------|---------------------------|-----|
|                                  |                                      | (1)                           | (2)                       |     |
| Description                      | Beginning Balance at January 1, 2003 | Charged to Costs and Expenses | Charged to other Accounts | Ded |
| Allowance for Sales Returns      | (1,725,000)                          | (21,589,000)                  | -                         |     |
| Allowance for Doubtful Accounts  | (50,000)                             | (131,000)                     | -                         |     |
| Inventory Reserves               | (560,000)                            | (440,000)                     | -                         |     |
| Deferred Tax Valuation Allowance | (22,501,000)                         | (2,299,000)                   | (2,072,000)               |     |

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ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None.

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### ITEM 9A. CONTROLS AND PROCEDURES

#### DISCLOSURE CONTROLS AND PROCEDURES

As of the end of the period covered by this Form 10-K, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer along with our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)). Based upon that evaluation, our Chief Executive Officer along with our Chief Financial Officer concluded that our disclosure controls and procedures are effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Exchange Act are recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms.

#### CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

There have been no changes in our internal control over financial reporting that occurred during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

### ITEM 9B. OTHER INFORMATION

None.

## PART III

### ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Our executive officers and directors, and their ages and positions, are as follows:

| NAME                  | AGE | POSITION  |
|-----------------------|-----|---|
| Alan Kane             | 63  | Chairman of the Board of Directors                  |
| Melissa Payner-Gregor | 46  | Chief Executive Officer and President               |
| Patrick C. Barry      | 43  | Chief Financial Officer and Chief Operating Officer |
| Barry Erdos           | 60  | Director  |
| Ann Jackson           | 53  | Director  |
| Martin Keane          | 40  | Senior Vice President of E-Commerce                 |
| Bradford Matson       | 48  | Chief Marketing Officer                             |
| Christopher G. McCann | 44  | Director  |
| Martin Miller         | 74  | Director  |
| Neal Moszkowski       | 39  | Director  |
| David Wassong         | 34  | Director  |

Alan Kane has served as a director since August 2002 and became Chairman of the Board in August 2004. Since September 2005, Mr. Kane has been the Dean of the Business School at the Fashion Institute of Technology (FIT). In addition, since September 1997, Mr. Kane has been the professor of retailing at the Columbia University Graduate School of Business. Before joining the Columbia Business School, Mr. Kane spent 28 years in the retailing industry. His experience in the retailing industry includes

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the following: President and Chief Executive Officer of Grossman's Eastern Division, a building materials retailer, from 1993 to 1994, President and Chief Executive Officer of Pergament Home Centers, a home center retailer, from 1991 to 1993, Private Consultant in the retailing industry from 1987 to 1991, and President and Chief Executive Officer of Hahne & Company, a department store chain and division of May Company, from 1979 to 1987. He has also served as a member of the Board of Directors of Circuit City Stores, Inc. an electronics retailer, since 2003.

Melissa Payner-Gregor, has served as our President since September 2003 and became Chief Executive Officer in August 2004. From December 2000 to March 2003, Ms. Payner-Gregor served as CEO and President of Spiegel Catalog. She was also a board member of The Spiegel Group, Inc. ("Spiegel") from December 2000 to March 2003. From 1997 to 2000, Ms. Payner-Gregor was the Senior Vice President of Merchandising and Advertising of Spiegel. Spiegel filed a plan of reorganization under Chapter 11 of the Federal Bankruptcy code in March 2003. From 1995 to 1997, Ms. Payner-Gregor was President and a board member of Chico FAS, Inc. Ms. Payner-Gregor has also held senior executive positions with Guess?, Inc., Pastille (a Division of Neiman Marcus) and Henri Bendel.

Patrick C. Barry served as an Executive Vice President from July 1998 to September 2000 and has been our Chief Financial Officer since August 1998. In September 2000, Mr. Barry assumed the role of Chief Operating Officer and has also served us in that capacity since such time. From June 1996 to July 1998, Mr. Barry served as the Chief Financial Officer and the Vice President of Operations of Audible, Inc., an Internet commerce and content provider. From March 1995 to June 1996, Mr. Barry was the Chief Financial Officer of Warner Music Enterprises, a direct marketing subsidiary of Time Warner, Inc. From July 1993 to March 1995, Mr. Barry served as Controller of Book-of-the-Month Club, a direct marketing subsidiary of Time Warner, Inc.

Barry Erdos has served as a director since February 2005. Since April 2004, Mr. Erdos has served as President and Chief Operating Officer of Build a Bear Workshop, Inc., a specialty retailer of plush animals and related products. Mr. Erdo has been a Director of Build a Bear Workshop, Inc. since July 2005. Mr. Erdos was the Chief Operating Officer and a director of Ann Taylor Stores Corporation and Ann Taylor Inc., a women's apparel retailer, from November 2001 to April 2004. He was Executive Vice President, Chief Financial Officer and Treasurer of Ann Taylor Stores Corporation and Ann Taylor Inc. from 1999 to 2001. Prior to that, he was Chief Operating Officer of J. Crew Group, Inc., a specialty retailer of apparel, shoes and accessories, from 1998 to 1999.

Ann Jackson has served as a director since August 2005. Ms. Jackson is currently the Chief Executive Officer of WRC Media, Inc. From 2003 to 2005 Ms. Jackson was a partner at private equity fund Ripplewood Holdings. From 1980 to 2003, Ms. Jackson worked in various departments and publications at Time, Inc. From 2002 to 2003, she served as Group President of InStyle, Real Simple, Parenting and Essence Magazines. She was the founding publisher of InStyle, which launched in 1994. During her tenure at Time, Inc., Ms. Jackson also held positions in corporate finance, direct mail for Time-Life Books Europe, served as business manager for Money Magazine and general manager for Sports Illustrated and People.

Martin Keane served as Vice President of Product Development and E-Commerce from January 1999 through September 2004 when he assumed the role of Senior Vice President of E-Commerce. From 1997 to 1999, Mr. Keane was the Design Director for Music Boulevard, an E-Commerce site owned by N2K, Inc. From 1990 to 1997, Mr. Keane served as Regional Manager for APCO Graphics, an architectural graphics company.

Bradford Matson has served as our Chief Marketing Officer since September 2005. Mr. Matson, was a marketing executive at Spiegel Catalog from 1981 to 2003,



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where he held various senior level positions, including Senior Vice President of Advertising and Brand Communications from 2001 to 2003, Vice President of Advertising from 2000 to 2001 and Vice President of Advertising and Marketing for Portfolio SBUs from 1997 to 1999. From 2004 to 2005, Mr. Matson served as Director of Marketing and Communications for the Steppenwolf Theatre Co.

Christopher G. McCann has served as a director since February 2005. Since September 2000, Mr. McCann has been the President of 1-800-flowers, a leading retailer of floral products and other gifts, and prior to that was that company's Senior Vice President. Mr. McCann has been a Director of 1-800-flowers since inception. Mr. McCann serves on the board of directors of Neoware, Inc., a provider of software, services and solutions to enable thin client appliance computing, and is a member of the Board of Trustees of the Marist College.

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Martin Miller has served as a director since July 1991. Since July 1999, Mr. Miller has served as the President of The Terbell Group, Inc., a consulting company. From October 1997 to April 2003, Mr. Miller has been a partner in the Belvedere Fund, L.P., a fund of hedge funds.

Neal Moszkowski has served as a director since August 1999 and is the Series A Preferred Stock designee. Since April 2005 Mr. Moszkowski has been Co-CEO of TowerBrook Capital Partners, L.P. ("TowerBrook"), a private equity investment company, based in the New York office. Prior to the formation of TowerBrook and since August 1998, Mr. Moszkowski was Co-Head of Soros Private Equity, a division of Soros Fund Management LLC and was a member of the Management Committee of Soros Fund Management LLC. Prior to joining Soros Private Equity, Mr. Moszkowski was an Executive Director of Goldman Sachs International and a Vice President of Goldman, Sachs & Co., an investment banking firm, in its Principal Investment Area. He joined Goldman, Sachs & Co. in August 1993. Mr. Moszkowski is also a Director of Integra Life Sciences Holdings, Inc., a medical products company, Wellcare Health Plans, Inc., a managed care services provider and Jet Blue Airways Corporation, a low fare airline.

David Wassong has served as a director since February 2001 and is the Series B Preferred Stock designee. Mr. Wassong has been a partner of Soros Private Equity since June 1998. Prior to joining Soros Private Equity, from July 1997 to June 1998, Mr. Wassong was Vice President, and previously Associate, at Lauder Gaspar Ventures, LLC, a media, entertainment and telecommunications-focused venture capital fund.

### CORPORATE GOVERNANCE

Our Board of Directors has reviewed the independence of each of our directors on the basis of the standards adopted by Nasdaq. In this review, the Board considered transactions and relationships between us, on the one hand, and each director, members of his or her immediate family, and other entities with which he or she is affiliated, on the other hand. As a result of this review, the Board of Directors affirmatively determined that Messrs. Miller, Kane, Erdos and McCann and Ms. Jackson are each "independent directors" within the meaning of the Nasdaq rules. Because Soros owns a majority of the voting power of our capital stock, the Board determined that it was appropriate for us to rely upon the "Controlled Company" exemption provided by Nasdaq rules. Accordingly, Nasdaq rules do not require that a majority of our Board of Directors be independent, and, similarly, do not require that all of the members of the Nominating Committee (as defined below) be independent.

The Board of Directors has established an Audit Committee ("Audit Committee") in accordance with Section 3(a)(58)(A) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). The Audit Committee is comprised of Barry Erdos,

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Chris McCann, Alan Kane and Martin Miller. Mr. Erdos is the Chairman of the Audit Committee. The Audit Committee is responsible for the appointment of our outside accountants, examining the results of audits, reviewing internal accounting controls and reviewing related party transactions. The Board has determined that Mr. Erdos is an "audit committee financial expert" within the meaning of the Securities and Exchange Commission's rules and that each member of the Audit Committee is "independent," as that term is used in Item 7(d)(3)(iv) of Schedule 14A promulgated under the Exchange Act.

The Board of Directors also has established an Option Plan/Compensation Committee ("Option Plan/Compensation Committee") consisting of Neal Moszkowski and Martin Miller. The Option Plan/Compensation Committee administers the Company's 1997 and 2000 Stock Option Plans, establishes the compensation levels for executive officers and key personnel and oversees the Company's bonus plans.

In June 2004, the Board of Directors established a Nominating and Governance Committee ("Nominating Committee"), consisting of Alan Kane and David Wassong. Mr. Kane is an independent director under Nasdaq rules. While Mr. Wassong is not an independent director under Nasdaq rules, he is permitted to sit on the Nominating Committee pursuant to the "Controlled Company" exemption discussed above. The purposes of the Nominating Committee are to assist the Board of Directors by identifying individuals qualified to become directors, and setting criteria for, and evaluating, candidates for director nominees, and to recommend to the Board of Directors the director nominees for election at the annual meetings of stockholders or for appointments to fill vacancies; recommend to the Board of Directors nominees for each committee of the Board; advise the Board of Directors about appropriate composition of the Board and its committees; advise the Board of Directors about and recommend to the Board of Directors appropriate corporate governance practices and to assist the Board of Directors in implementing those practices; lead the Board of Directors in its annual review of the performance of the Board and its committees; and perform such other functions as the Board of Directors may assign to it from time to time.

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We have adopted a Code of Ethics applicable to all directors, officers and employees, which meets the requirements of a "code of ethics" as defined in Item 406 of Regulation S-K, and we maintain procedures for the confidential, anonymous submission by employees of complaints regarding our accounting, internal accounting controls, auditing matters and other issues. A copy of our code of ethics is available on the Company's Web site at [www.bluefly.com](http://www.bluefly.com). Any amendment to or waiver of a provision of the code of ethics that applies to our principal executive officer, principal financial officer, principal accounting officer, controller or persons performing similar functions and relates to elements of the code specified in the rules of the Securities and Exchange Commission will be posted on the Web site.

### SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Exchange Act requires our directors and executive officers and persons who beneficially own more than ten percent of our Common Stock (collectively, the "Reporting Persons") to file with the Securities and Exchange Commission initial reports of beneficial ownership and reports of changes in beneficial ownership of the Common Stock. Reporting Persons are required to furnish us with copies of all such reports. During 2005, Martin Keane, our Senior Vice President of E-Commerce, was late in filing a Form 4 relating to a stock option grant, but did file the required form. To our knowledge, based solely on a review of copies of such reports furnished to us, we believe that during the 2005 fiscal year all Reporting Persons complied with all applicable Section 16(a) reporting requirements except as noted above.

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### ITEM 11. EXECUTIVE COMPENSATION

#### COMPENSATION OF DIRECTORS

Our independent, outside non-employee directors are paid a cash stipend of \$1,500 for each board or committee meeting attended in person (and, in the case of the Audit Committee Chairman, \$2,000 per meeting) and are reimbursed for expenses incurred on our behalf. In addition, each such director is paid an annual retainer of \$10,000 at the first regularly scheduled Board meeting of each fiscal year. The maximum aggregate stipend and retainer paid to any such director in a year is \$16,000 (or, in the case of the Audit Committee Chairman, \$18,000).

Each non-employee director receives an option to purchase 15,000 shares of Common Stock (25,000 shares in the case of the Chairman of the Board and 20,000 shares in the case of the Chairman of the Audit Committee) at the time of the first regularly scheduled Board meeting after such director is appointed to the Board and an annual grant of an option to purchase 10,000 shares of Common Stock (20,000 shares in the case of the Chairman of the Board and 12,500 shares in the case of the Chairman of the Audit Committee) at the first regularly scheduled Board meeting of each fiscal year (even if such director is receiving an option in connection with his or her appointment at such meeting).

#### COMPENSATION OF EXECUTIVE OFFICERS

The following table sets forth information concerning the compensation paid by us during the fiscal years ended December 31, 2005, 2004 and 2003 to our Chief Executive Officer, and our three other executive officers who received total compensation from us in excess of \$100,000 in the year 2005 (the "Named Executive Officers").

| NAME AND PRINCIPAL POSITION  | YEAR | ANNUAL COMPENSATION |                |        | OTHER ANNUAL<br>COMPENSATION | LONG-TERM<br>COMPENSATION |
|--|------|---------------------|----------------|--------|------------------------------|---------------------------|
|  |      | SALARY              | BONUS          |        |                              |                           |
| Melissa Payner-Gregor<br>Chief Executive Officer and President             | 2005 | \$ 488,462          | \$ 100,000 (4) | \$ 655 | 45                           |                           |
|  | 2004 | \$ 466,960          | \$ 295,000 (3) | \$ 655 | 70                           |                           |
|  | 2003 | \$ 112,500          | --             | \$ --  | 1,200                        |                           |
| Patrick C. Barry<br>Chief Financial Officer and Chief<br>Operating Officer | 2005 | \$ 300,000          | \$ 50,000 (4)  | \$ 590 | 30                           |                           |
|  | 2004 | \$ 260,429          | \$ 170,000     | \$ 590 | 30                           |                           |
|  | 2003 | \$ 225,000          | --             | \$ 590 |                              |                           |
| Bradford Matson<br>Chief Marketing Officer                                 | 2005 | 100,962             | \$ 20,000 (4)  | \$ --  | 50                           |                           |
| Martin Keane<br>Senior Vice President of E-Commerce                        | 2005 | \$ 182,500          | \$ 25,000 (4)  | --     | 7                            |                           |
|  | 2004 | \$ 171,538          | \$ 25,000      | \$ --  |                              |                           |
|  | 2003 | \$ 152,308          | \$ 20,000      | \$ --  |                              |                           |

(1) Options granted at an exercise price equal to 100% of the fair market value on the date of grant.

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- (2) Options granted at an exercise price equal to 100% of the fair market value on the date of grant, except for 100,000 options that, pursuant to Ms. Payner-Gregor's employment agreement, were granted at an exercise price of \$1.56 (the fair market value of the Common Stock on the date of Ms. Payner-Gregor's employment agreement). The fair market value of the common stock on the date of grant of such options was \$2.49 per share.
- (3) Includes \$75,000 paid to Ms. Payner-Gregor in connection with her relocation to New York in accordance with her employment agreement.
- (4) Earned in 2005 but will be paid in 2006.

### COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION

The members of the Option Plan/Compensation Committee are Neal Moszkowski and Martin Miller. No member of our Option Plan/Compensation Committee has at any time been an employee of ours. None of our executive officers serves as a member of the board of directors or compensation committee of any entity that has one or more executive officers serving as a member of our board of directors or Option Plan/Compensation Committee.

### EMPLOYMENT AGREEMENTS

We currently have employment agreements with Ms. Payner-Gregor, Mr. Barry, Mr. Matson and Mr. Keane. Each such employment agreement provides for a base salary, subject to increase by the Compensation Committee, and an annual bonus to be determined by the Compensation Committee. Currently, their annual salaries are \$500,000, \$300,000, \$350,000 and \$190,000, respectively. Ms. Payner-Gregor's annual bonus for each fiscal year during her agreement cannot be less than 3% of our net income for such fiscal year, subject to a cap equal to 200% of her base salary. Her bonus is subject to a minimum floor of \$100,000. Mr. Matson is entitled to receive a minimum bonus of \$50,000 for the year ended December 31, 2006.

The employment agreements for Ms. Payner-Gregor, Mr. Barry, Mr. Matson and Mr. Keane terminate on March 1, 2007, June 30, 2006, September 19, 2008 and March 1, 2008, respectively. The employment agreements with Ms. Payner-Gregor and Mr. Barry include provisions pursuant to which the agreement is automatically renewed for successive one year terms unless one party provides notice to the other of such party's desire not to renew such agreement at least 90 days prior to the end of the then-current term of such agreement.

Each of these employment agreements obligates the Company to make severance payments equal to up to six months' salary in connection with a termination by the Company of such Named Executive Officer's employment, other than for cause, and also provides for the immediate vesting of any stock options held by them under such circumstances. Ms. Payner-Gregor's and Mr. Barry's employment agreements also provide for the immediate vesting of any stock options held by such Named Executive Officer upon the occurrence of certain events classified as a "Change In Control". In addition, Ms. Payner-Gregor's and Mr. Barry's employment agreements provide that upon the occurrence of certain events classified as a "Change of Control" in which cash, securities or other consideration is paid or payable, or otherwise to be distributed directly to the Company's stockholders, each such Named Executive shall receive a bonus equal to a percentage of the proceeds received by the Company's stockholders.

### OPTION GRANTS IN LAST FISCAL YEAR

The following table contains information concerning the grant of stock options to the Named Executives Officers during the fiscal year ended December 31, 2005:

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| NAME                  | INDIVIDUAL GRANTS                                   |  |                             |  | EXPIRATION DATE | POTENTIAL ANNUAL PRICE FOR 5% |
|-----------------------|---|--|-----------------------------|--|-----------------|-------------------------------|
|                       | NUMBER OF SECURITIES UNDERLYING OPTIONS GRANTED (#) | % OF TOTAL OPTIONS GRANTED TO EMPLOYEES IN FISCAL YEAR (%) | EXERCISE OR BASE PRICE (\$) |  |                 |                               |
| Melissa Payner-Gregor | 200,000   | 10.46%   | \$ 1.26                     |  | 3/23/15         | \$ 291,7                      |
|                       | 250,000   | 13.07%   | \$ 1.20                     |  | 12/27/15        | \$ 347,2                      |
| Patrick C. Barry      | 100,000   | 5.23%  | \$ 1.26                     |  | 3/23/15         | \$ 145,8                      |
|                       | 200,000   | 10.46%   | \$ 1.20                     |  | 12/27/15        | \$ 277,8                      |
| Bradford Matson       | 400,000   | 20.92%   | \$ 1.69                     |  | 9/19/15         | \$ 782,5                      |
|                       | 100,000   | 5.23%  | \$ 1.20                     |  | 12/27/15        | \$ 138,9                      |
| Martin Keane          | 50,000  | 2.61%  | \$ 1.26                     |  | 3/23/15         | \$ 72,9                       |
|                       | 20,000  | 1.05%  | \$ 1.54                     |  | 9/30/15         | \$ 35,6                       |

The Company does not currently grant stock appreciation rights.

OPTION HOLDINGS

The following table sets forth information with respect to the Named Executive Officers concerning the number and value of unexercised options held at December 31, 2005.

| NAME                  | SHARES ACQUIRED ON EXERCISE # | VALUE REALIZED \$ | SECURITIES UNDERLYING UNEXERCISED OPTIONS AT DECEMBER 31, 2005 (#) |               | EXERCISE PRICE |
|-----------------------|-------------------------------|-------------------|--|---------------|----------------|
|                       |                               |                   | EXERCISABLE  | UNEXERCISABLE |                |
| Melissa Payner-Gregor | --                            | --                | 1,280,247  | 1,069,753     |                |
| Patrick C. Barry      | --                            | --                | 1,805,322  | 439,590       | \$             |
| Bradford Matson       | --                            | --                | --   | 500,000       |                |
| Martin Keane          | --                            | --                | 410,622  | 59,378        | \$             |

(1) Represents the value of unexercised, in-the-money stock options at December 30, 2005, using the \$1.12 closing price of the Common Stock on that date.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

COMMON STOCK

The following table sets forth certain information with respect to the beneficial ownership of the Common Stock of the Company as of February 17, 2006, for (i) each person who is known by the Company to own beneficially more than 5% of the Common Stock, (ii) each of the Company's directors, (iii) the Named Executive Officers, and (iv) all directors and executive officers as a group.

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| NAME (1)         | NUMBER OF SHARES<br>BENEFICIALLY OWNED | PERCENTAGE (2) |
|------------------|--|----------------|
| Patrick C. Barry | 1,816,572 (3)                          | 8.1%           |
| Barry Erdos      | 32,500 (4)                             | *              |
| Ann Jackson      | --                                     | *              |

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| NAME (1)   | NUMBER OF SHARES<br>BENEFICIALLY OWNED | PERCENTAGE (2) |
|--|--|----------------|
| Alan Kane  | 52,500 (5)                             | *              |
| Martin Keane   | 440,017 (6)                            | 2.1%           |
| Bradford Matson  | 8,333 (7)                              | *              |
| Martin Miller  | 45,000 (8) (9)                         | *              |
| Neal Moszkowski (10)   | 32,500 (11)                            | *              |
| Christopher G. McCann  | 25,000 (12)                            | *              |
| Melissa Payner-Gregor  | 1,479,341 (13)                         | 6.7%           |
| David Wassong (14)   | 25,000 (15)                            | *              |
| SFM Domestic Investments LLC                                 | 1,509,486 (16) (20)                    | 6.9%           |
| Quantum Industrial Partners LDC                              | 46,127,113 (17) (20)                   | 75.2%          |
| George Soros   | 47,636,602 (18) (20)                   | 76.0%          |
| All directors and executive officers as a group (11 persons) | 3,956,763 (19)                         | 16.2%          |

\*Less than 1%.

- (1) Except as otherwise indicated, the address of each of the individuals listed is c/o Bluefly, Inc., 42 West 39th Street, New York, New York 10018.
- (2) Beneficial ownership is determined in accordance with the rules of the Commission and generally includes voting or investment power with respect to securities. Shares of Common Stock issuable upon the exercise of options or warrants currently exercisable or exercisable within 60 days are deemed outstanding for computing the percentage ownership of the person holding such options or warrants but are not deemed outstanding for computing the percentage ownership of any other person.
- (3) Includes 1,811,572 shares of Common Stock issuable upon exercise of options granted under the Plan.
- (4) Includes 32,500 shares of Common Stock issuable upon exercise of options granted under the Plan.
- (5) Includes 52,500 shares of Common Stock issuable upon exercise of options granted under the Plan.
- (6) Includes 440,017 shares of Common Stock issuable upon exercise of options granted under the Plan.
- (7) Includes 8,333 shares of Common Stock issuable upon exercise of options granted under the Plan.
- (8) Includes 3,000 shares of Common Stock held by Madge Miller, the wife of Martin Miller, as to which Mr. Miller disclaims beneficial ownership.
- (9) Includes 42,000 shares of Common Stock issuable upon exercise of options granted under the Plan.
- (10) Mr. Moszkowski's address is c/o, TowerBrook Capital Partners, L.P., 430 Park Avenue New York, New York, 10022. Mr. Moszkowski is the designee of

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the holders of the Series A Preferred Stock. Mr. Moszkowski disclaims beneficial ownership of the shares of Common Stock beneficially owned by George Soros, SFMDI and QIP (as defined in notes (15) and (16) below) and none of such shares are included in the table above as being beneficially owned by him.

- (11) Includes 32,500 shares of Common Stock issuable upon exercise of options granted under the Plan. Certain of the options are held for the benefit of QIP.
- (12) Includes 25,000 shares of Common Stock issuable upon exercise of options granted under the Plan.
- (13) Includes 1,479,341 shares of Common Stock issuable upon exercise of options granted under the Plan.
- (14) Mr. Wassong's address is c/o Soros Fund Management LLC, 888 Seventh Avenue, 33rd floor, New York, New York 10106. Mr. Wassong is the designee of the holders of the Series B Preferred Stock. Mr. Wassong disclaims beneficial ownership of the shares of Common Stock beneficially owned by George Soros, SFMDI and QIP (as defined in notes (15) and (16) below) and none of such shares are included in the table above as being beneficially owned by him.
- (15) Includes 25,000 shares of Common Stock issuable upon exercise of options granted under the Plan. Certain of the options are held for the benefit of QIP.
- (16) Represents: 124,700 shares of Common Stock issuable upon conversion of 14,590 shares of Series A Preferred Stock; 866,942 shares of Common Stock issuable upon conversion of 281,571 shares of Series B Preferred Stock; 41,710 shares of Common Stock issuable upon conversion of 31.7 shares of Series C Preferred Stock; 201,091 shares of Common Stock issuable upon conversion of 152.829 shares of Series D Preferred Stock; 41,710 shares of Common

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Stock issuable upon conversion of 31.7 shares of Series E Preferred Stock; 41,121 shares of Common Stock issuable upon conversion of 95.4 shares of Series F Preferred Stock; 172,995 shares of Common Stock; 19,220 shares of Common Stock issuable upon exercise of warrants (collectively, the "SFMDI Shares") held in the name of SFM Domestic Investments LLC ("SFMDI"). SFMDI is a Delaware limited liability company. As sole managing member of SFMDI, George Soros ("Mr. Soros") may also be deemed the beneficial owner of the SFMDI Shares. The principal address of SFMDI is at 888 Seventh Avenue, 33rd Floor, New York, New York 10106. The foregoing information was derived, in part, from certain publicly available reports, statements and schedules filed with the Commission.

- (17) Represents: 3,806,923 shares of Common Stock issuable upon conversion of 445,410 shares Series A Preferred Stock; 26,503,095 shares of Common Stock issuable upon conversion of 8,607,843 shares of Series B Preferred Stock; 1,274,078 shares of Common Stock issuable upon conversion of 968.3 shares of Series C Preferred Stock; 6,142,450 shares of Common Stock issuable upon conversion of 4,668.262 shares of Series D Preferred Stock; 1,274,078 shares of Common Stock issuable upon conversion of 968.3 shares of Series E Preferred Stock; 1,251,983 shares of Common Stock issuable upon conversion of 2,904.6 shares of Series F Preferred Stock; 5,287,082 shares of Common Stock; 587,424 shares of Common Stock issuable upon exercise of warrants (collectively, the "QIP Shares") held in the name of Quantum Industrial Partners LDC ("QIP"). QIP is an exempted limited duration company formed under the laws of the Cayman Islands with its principal address at Kaya Flamboyen 9, Willemstad, Curacao, Netherlands Antilles. QIH Management Investor, L.P. ("QIHMI"), an investment advisory firm organized as a Delaware limited partnership, is a minority shareholder of, and is vested with investment discretion with respect to portfolio assets held for the account of QIP. The sole general partner of QIHMI is QIH Management LLC, a Delaware limited liability company ("QIH Management"). Soros Fund

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Management LLC, a Delaware limited liability company ("SFM"), is the sole managing member of QIH Management Mr. Soros, as Chairman of SFM, may be deemed to have shared voting power and sole investment power with respect to the QIP Shares. Accordingly, each of QIP, QIHMI, QIH Management, SFM and Mr. Soros may be deemed to be the beneficial owners of the QIP Shares. Each has their principal office at 888 Seventh Avenue, 33rd Floor, New York, New York 10106. The foregoing information was derived, in part, from certain publicly available reports, statements and schedules filed with the Commission.

(18) See (16) and (17) above.

(19) Includes 3,948,763 shares of Common Stock issuable upon exercise of options.

(20) See "Risk Factors - Soros Owns a Majority of Our Stock."

### SERIES A PREFERRED STOCK

The following table sets forth certain information with respect to the beneficial ownership of the Series A Preferred Stock of the Company as of February 17, 2006, for (i) each person who is known by the Company to own beneficially more than 5% of the Series A Preferred Stock of the Company, (ii) each of the Company's directors, (iii) the Named Executive Officers, and (iv) all directors and executive officers as a group.

| NAME (1)                        | NUMBER OF SHARES<br>BENEFICIALLY OWNED | PERCENTAGE (2) |
|---------------------------------|--|----------------|
| Patrick C. Barry                | -                                      | -              |
| Barry Erdos                     | -                                      | -              |
| Ann Jackson                     | -                                      | -              |
| Alan Kane                       | -                                      | -              |
| Martin Keane                    | -                                      | -              |
| Bradford Matson                 | -                                      | -              |
| Martin Miller                   | -                                      | -              |
| Neal Moszkowski (3)             | -                                      | -              |
| Christopher G. McCann           | -                                      | -              |
| Melissa Payner-Gregor           | -                                      | -              |
| David Wassong (3)               | -                                      | -              |
| Quantum Industrial Partners LDC | 445,410 (4) (6)                        | 96.8%          |
| George Soros                    | 460,000 (5) (6)                        | 100.0%         |

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| NAME (1)  | NUMBER OF SHARES<br>BENEFICIALLY OWNED | PERCENTAGE (2) |
|---|--|----------------|
| All directors and executive officers<br>as a group (11 persons) | -                                      | -              |

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\*Less than 1%.

(1) Except as otherwise indicated, the address of each of the individuals listed is c/o Bluefly, Inc., 42 West 39th Street, New York, New York 10018.



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- (2) Beneficial ownership is determined in accordance with the rules of the Commission and generally includes voting or investment power with respect to securities. Shares of Common Stock issuable upon the exercise of options or warrants currently exercisable or exercisable within 60 days are deemed outstanding for computing the percentage ownership of the person holding such options or warrants but are not deemed outstanding for computing the percentage ownership of any other person.
- (3) Mr. Moszkowski's address is c/o TowerBrook Capital Partners, L.P., 430 Park Avenue New York, New York 10022 and Mr. Wassong's address is c/o Soros Fund Management LLC, 888 Seventh Avenue, 33rd Floor, New York, New York 10106. Messrs. Moszkowski and Wassong are the designees of the holders of the Series A and B Preferred Stock. Messrs. Moszkowski and Wassong disclaim beneficial ownership of the Series A Preferred Stock beneficially owned by George Soros and QIP and none of such shares are included in the table above as being beneficially owned by them.
- (4) Represents the shares of Series A Preferred Stock held in the name of QIP (the "QIP A Shares"). QIP is an exempted limited duration company formed under the laws of the Cayman Islands, with its principal address at Kaya Flamboyen 9, Willemstad, Curacao, Netherlands Antilles. QIHMI, an investment advisory firm organized as a Delaware limited partnership, is a minority shareholder of, and is vested with investment discretion with respect to portfolio assets held for the account of QIP. The sole general partner of QIHMI is QIH Management. SFM is the sole managing member of QIH Management. Mr. Soros, as Chairman of SFM, may be deemed to have shared voting power and sole investment power with respect to the QIP A Shares. Accordingly, each of QIHMI, QIH Management, SFM and Mr. Soros may be deemed to be beneficial owners of the QIP Shares. Each has their principal office at 888 Seventh Avenue, 33rd Floor, New York, New York 10106. The foregoing information was derived, in part, from certain publicly available reports, statements and schedules filed with the Commission.
- (5) Represents both (i) 14,590 shares of Series A Preferred Stock held in the name of SFMDI (the "SFMDI A Shares") and (ii) the QIP A Shares referenced in Note 4 above. As sole managing member of SFMDI, Mr. Soros also may be deemed the beneficial owner of the SFMDI A Shares. The principal office of SFMDI is at 888 Seventh Avenue, 33rd Floor, New York, New York 10106.
- (6) See "Risk Factors - Change of Control Covenant and Liquidation Preference of Preferred Stock."

SERIES B PREFERRED STOCK

The following table sets forth certain information with respect to the beneficial ownership of the Series B Preferred Stock of the Company as of February 17, 2006, for (i) each person who is known by the Company to own beneficially more than 5% of the Series B Preferred Stock of the Company, (ii) each of the Company's directors, (iii) the Named Executive Officers, and (iv) all directors and executive officers as a group.

| NAME (1)            | NUMBER OF SHARES<br>BENEFICIALLY OWNED | PERCENTAGE (2) |
|---------------------|--|----------------|
| Patrick C. Barry    | -                                      | -              |
| Barry Erdos         | -                                      | -              |
| Ann Jackson         | -                                      | -              |
| Alan Kane           | -                                      | -              |
| Martin Keane        | -                                      | -              |
| Bradford Matson     | -                                      | -              |
| Martin Miller       | -                                      | -              |
| Neal Moszkowski (3) | -                                      | -              |

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| NAME (1)  | NUMBER OF SHARES<br>BENEFICIALLY OWNED | PERCENTAGE (2) |
|---|--|----------------|
| Christopher G. McCann   | -                                      | -              |
| Melissa Payner-Gregor   | -                                      | -              |
| David Wassong (3)   | -                                      | -              |
| Quantum Industrial Partners LDC                                 | 8,607,843 (4) (6)                      | 96.8%          |
| George Soros  | 8,889,414 (5) (6)                      | 100.0%         |
| All directors and executive officers<br>as a group (11 persons) | -                                      | -              |

\*Less than 1%.

- (1) Except as otherwise indicated, the address of each of the individuals listed is c/o Bluefly, Inc., 42 West 39th Street, New York, New York 10018.
- (2) Beneficial ownership is determined in accordance with the rules of the Commission and generally includes voting or investment power with respect to securities. Shares of Common Stock issuable upon the exercise of options or warrants currently exercisable or exercisable within 60 days are deemed outstanding for computing the percentage ownership of the person holding such options or warrants but are not deemed outstanding for computing the percentage ownership of any other person.
- (3) Mr. Moszkowski's address is c/o TowerBrook Capital Partners, L.P., 430 Park Avenue New York, New York 10022 and Mr. Wassong's address is c/o Soros Fund Management LLC, 888 Seventh Avenue, 33rd Floor, New York, New York 10106. Messrs. Moszkowski and Wassong are the designees of the holders of the Series A and B Preferred Stock. Messrs. Moszkowski and Wassong disclaim beneficial ownership of the shares of Series B Preferred Stock beneficially owned by George Soros and QIP and none of such shares are included in the table above as being beneficially owned by them.
- (4) Represents the shares of Series B Preferred Stock held in the name of QIP (the "QIP B Shares"). QIP is an exempted limited duration company formed under the laws of the Cayman Islands, with its principal address at Kaya Flamboyen 9, Willemstad, Curacao, Netherlands Antilles. QIHMI, an investment advisory firm organized as a Delaware limited partnership, is a minority shareholder of, and is vested with investment discretion with respect to portfolio assets held for the account of QIP. The sole general partner of QIHMI is QIH Management. SFM is the sole managing member of QIH Management. Mr. Soros, as Chairman of SFM, may be deemed to have shared voting power and sole investment power with respect to the QIP B Shares. Accordingly, each of QIHMI, QIH Management, SFM and Mr. Soros may be deemed to be beneficial owners of the QIP Shares. Each has their principal office at 888 Seventh Avenue, 33rd Floor, New York, New York 10106. The foregoing information was derived, in part, from certain publicly available reports, statements and schedules filed with the Commission.
- (5) Represents both (i) 281,571 shares of Series B Preferred Stock held in the name of SFMDI (the "SFMDI B Shares") and (ii) the QIP B Shares referenced in Note 4 above. As managing member of SFMDI, Mr. Soros also may be deemed the beneficial owner of the SFMDI Shares. The principal office of SFMDI is at 888 Seventh Avenue, 33rd Floor, New York, New York 10106.
- (6) See "Risk Factors - Change of Control Covenant and Liquidation Preference of Preferred Stock."

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SERIES C PREFERRED STOCK

The following table sets forth certain information with respect to the beneficial ownership of the Series C Preferred Stock of the Corporation as of February 17, 2006, for (i) each person who is known by the Corporation to own beneficially more than 5% of the Series C Preferred Stock of the Corporation, (ii) each of the Corporation's directors, (iii) the Named Executives, and (iv) all directors and executive officers as a group.

| NAME (1)         | NUMBER OF SHARES<br>BENEFICIALLY OWNED | PERCENTAGE (2) |
|------------------|--|----------------|
| Patrick C. Barry | -                                      | -              |
| Barry Erdos      | -                                      | -              |

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| NAME (1)  | NUMBER OF SHARES<br>BENEFICIALLY OWNED | PERCENTAGE (2) |
|---|--|----------------|
| Ann Jackson   | -                                      | -              |
| Alan Kane   | -                                      | -              |
| Martin Keane  | -                                      | -              |
| Bradford Matson   | -                                      | -              |
| Martin Miller   | -                                      | -              |
| Neal Moszkowski (3)   | -                                      | -              |
| Christopher G. McCann   | -                                      | -              |
| Melissa Payner-Gregor   | -                                      | -              |
| David Wassong (3)   | -                                      | -              |
| Quantum Industrial Partners LDC                                 | 968.3(4)(6)                            | 96.8%          |
| George Soros  | 1,000.0(5)(6)                          | 100.0%         |
| All directors and executive officers as<br>a group (11 persons) | -                                      | -              |

\*Less than 1%.

- (1) Except as otherwise indicated, the address of each of the individuals listed is c/o Bluefly, Inc., 42 West 39th Street, New York, New York 10018.
- (2) Beneficial ownership is determined in accordance with the rules of the Commission and generally includes voting or investment power with respect to securities. Shares of Common Stock issuable upon the exercise of options or warrants currently exercisable or exercisable within 60 days are deemed outstanding for computing the percentage ownership of the person holding such options or warrants but are not deemed outstanding for computing the percentage ownership of any other person.
- (3) Mr. Moszkowski's address is c/o TowerBrook Capital Partners, L.P., 430 Park Avenue New York, New York 10022 and Mr. Wassong's address is c/o Soros Fund Management LLC, 888 Seventh Avenue, 33rd Floor, New York, New York 10106. Messrs. Moszkowski and Wassong are the designees of the holders of the Series A and B Preferred Stock. Messrs. Moszkowski and Wassong disclaim beneficial ownership of the shares of Series C Preferred Stock beneficially owned by George Soros and QIP and none of such shares are included in the table above as being beneficially owned by them.

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- (4) Represents the shares of Series C Preferred Stock held in the name of QIP (the "QIP C Shares"). QIP is an exempted limited duration company formed under the laws of the Cayman Islands, with its principal address at Kaya Flamboyen 9, Willemstad, Curacao, Netherlands Antilles. QIHMI, an investment advisory firm organized as a Delaware limited partnership, is a minority shareholder of, and is vested with investment discretion with respect to portfolio assets held for the account of QIP. The sole general partner of QIHMI is QIH Management. SFM is the sole managing member of QIH Management. Mr. Soros, as Chairman of SFM, may be deemed to have shared voting power and sole investment power with respect to the QIP C Shares. Accordingly, each of QIHMI, QIH Management, SFM and Mr. Soros may be deemed to be beneficial owners of the QIP Shares. Each has their principal office at 888 Seventh Avenue, 33rd Floor, New York, New York 10106. The foregoing information was derived, in part, from certain publicly available reports, statements and schedules filed with the Commission.
- (5) Represents both (i) 31.7 shares of Series C Preferred Stock held in the name of SFMDI (the "SFMDI C Shares") and (ii) the QIP C Shares referenced in Note 4 above. As managing member of SFMDI, Mr. Soros also may be deemed the beneficial owner of the SFMDI C Shares. The principal office of SFMDI is at 888 Seventh Avenue, 33rd Floor, New York, New York 10106.
- (6) See "Risk Factors - Change of Control Covenant and Liquidation Preference of Preferred Stock."

SERIES D PREFERRED STOCK

The following table sets forth certain information with respect to the beneficial ownership of the Series D Preferred Stock of the Company as of February 17, 2006, for (i) each person who is known by the Company to own beneficially more than 5% of the Series D Preferred Stock of the Company, (ii) each of the Company's directors, (iii) the Named Executives, and (iv) all directors and executive officers as a group.

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| NAME (1)  | NUMBER OF SHARES<br>BENEFICIALLY OWNED | PERCENTAGE (2) |
|---|--|----------------|
| Patrick C. Barry  | -                                      | -              |
| Barry Erdos   | -                                      | -              |
| Ann Jackson   | -                                      | -              |
| Alan Kane   | -                                      | -              |
| Martin Keane  | -                                      | -              |
| Bradford Matson   | -                                      | -              |
| Martin Miller   | -                                      | -              |
| Neal Moszkowski (3)   | -                                      | -              |
| Christopher G. McCann   | -                                      | -              |
| Melissa Payner-Gregor   | -                                      | -              |
| David Wassong (3)   | -                                      | -              |
| Portside Growth and Opportunity Fund(4)                         | 330.78                                 | 5.7%           |
| Quantum Industrial Partners LDC                                 | 4,668.26(5) (7)                        | 80.3%          |
| George Soros  | 4,821.09(6) (7)                        | 82.9%          |
| All directors and executive officers as<br>a group (11 persons) | -                                      | -              |

\*Less than 1%.

(1) Except as otherwise indicated, the address of each of the individuals

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- listed is c/o Bluefly, Inc., 42 West 39th Street, New York, New York 10018.
- (2) Beneficial ownership is determined in accordance with the rules of the Commission and generally includes voting or investment power with respect to securities. Shares of Common Stock issuable upon the exercise of options or warrants currently exercisable or exercisable within 60 days are deemed outstanding for computing the percentage ownership of the person holding such options or warrants but are not deemed outstanding for computing the percentage ownership of any other person.
  - (3) Mr. Moszkowski's address is c/o TowerBrook Capital Partners, L.P., 430 Park Avenue New York, New York 10022 and Mr. Wassong's address is c/o Soros Fund Management LLC, 888 Seventh Avenue, 33rd Floor, New York, New York 10106. Messrs. Moszkowski and Wassong are the designees of the holders of the Series A and B Preferred Stock. Messrs. Moszkowski and Wassong disclaim beneficial ownership of the shares of Series D Preferred Stock beneficially owned by George Soros and QIP and none of such shares are included in the table above as being beneficially owned by them.
  - (4) Ramius Capital Group, LLC ("Ramius Capital") is the investment advisor of Portside Growth and Opportunity Fund ("Portside") and consequently has voting and investment power over securities held by Portside. Ramius Capital disclaims beneficial ownership of the shares held by Portside. Peter A. Cohen, Morgan B. Stark, Thomas W. Strauss and Jeffrey M. Solomon are the sole managing members of C4S & Co., LLC, the sole managing member of Ramius Capital. As a result, Messrs. Cohen, Stark, Strauss and Solomon may be considered beneficial owners of any shares deemed to be beneficially owned by Ramius Capital. Messrs. Cohen, Stark, Strauss and Solomon disclaim beneficial ownership of these shares.
  - (5) Represents the shares of Series D Preferred Stock held in the name of QIP (the "QIP D Shares"). QIP is an exempted limited duration company formed under the laws of the Cayman Islands, with its principal address at Kaya Flamboyan 9, Willemstad, Curacao, Netherlands Antilles. QIHMI, an investment advisory firm organized as a Delaware limited partnership, is a minority shareholder of, and is vested with investment discretion with respect to portfolio assets held for the account of QIP. The sole general partner of QIHMI is QIH Management. SFM is the sole managing member of QIH Management. Mr. Soros, as Chairman of SFM, may be deemed to have shared voting power and sole investment power with respect to the QIP D Shares. Accordingly, each of QIHMI, QIH Management, SFM and Mr. Soros may be deemed to be beneficial owners of the QIP Shares. Each has their principal office at 888 Seventh Avenue, 33rd Floor, New York, New York 10106. The foregoing information was derived, in part, from certain publicly available reports, statements and schedules filed with the Commission.

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- (6) Represents both (i) 152.829 shares of Series D Preferred Stock held in the name of SFMDI (the "SFMDI D Shares") and (ii) the QIP D Shares referenced in Note 4 above. As managing member of SFMDI, Mr. Soros also may be deemed the beneficial owner of the SFMDI D Shares. The principal office of SFMDI is at 888 Seventh Avenue, 33rd Floor, New York, New York 10106.
- (7) See "Risk Factors - Change of Control Covenant and Liquidation Preference of Preferred Stock."

### SERIES E PREFERRED STOCK

The following table sets forth certain information with respect to the beneficial ownership of the Series D Preferred Stock of the Company as of February 17, 2006, for (i) each person who is known by the Company to own beneficially more than 5% of the Series D Preferred Stock of the Company, (ii) each of the Company's directors, (iii) the Named Executives, and (iv) all directors and executive officers as a group.

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| NAME (1)  | NUMBER OF SHARES<br>BENEFICIALLY OWNED | PERCENTAGE (2) |
|---|--|----------------|
| Patrick C. Barry  | -                                      | -              |
| Barry Erdos   | -                                      | -              |
| Ann Jackson   | -                                      | -              |
| Alan Kane   | -                                      | -              |
| Martin Keane  | -                                      | -              |
| Bradford Matson   | -                                      | -              |
| Martin Miller   | -                                      | -              |
| Neal Moszkowski (3)   | -                                      | -              |
| Christopher G. McCann   | -                                      | -              |
| Melissa Payner-Gregor   | -                                      | -              |
| David Wassong (3)   | -                                      | -              |
| Quantum Industrial Partners LDC                                 | 968.3 (4) (6)                          | 96.8%          |
| George Soros  | 1,000 (5) (6)                          | 100.0%         |
| All directors and executive officers as<br>a group (11 persons) | -                                      | -              |

\*Less than 1%.

- (1) Except as otherwise indicated, the address of each of the individuals listed is c/o Bluefly, Inc., 42 West 39th Street, New York, New York 10018.
- (2) Beneficial ownership is determined in accordance with the rules of the Commission and generally includes voting or investment power with respect to securities. Shares of Common Stock issuable upon the exercise of options or warrants currently exercisable or exercisable within 60 days are deemed outstanding for computing the percentage ownership of the person holding such options or warrants but are not deemed outstanding for computing the percentage ownership of any other person.
- (3) Mr. Moszkowski's address is c/o TowerBrook Capital Partners L.P., 430 Park Avenue New York, New York 10022 and Mr. Wassong's address is c/o Soros Fund Management LLC, 888 Seventh Avenue, 33rd Floor, New York, New York 10106. Messrs. Moszkowski and Wassong are the designees of the holders of the Series A and B Preferred Stock. Messrs. Moszkowski and Wassong disclaim beneficial ownership of the shares of Series E Preferred Stock beneficially owned by George Soros and QIP and none of such shares are included in the table above as being beneficially owned by them.
- (4) Represents the shares of Series E Preferred Stock held in the name of QIP (the "QIP E Shares"). QIP is an exempted limited duration company formed under the laws of the Cayman Islands, with its principal address at Kaya Flamboyen 9, Willemstad, Curacao, Netherlands Antilles. QIHMI, an investment advisory firm organized as a Delaware limited partnership, is a minority shareholder of, and is vested with investment discretion with respect to portfolio assets held for the account of QIP. The sole general partner of QIHMI is QIH Management. SFM is the sole managing member of QIH Management. Mr. Soros, as Chairman of SFM, may be deemed to have shared voting power and sole investment power with respect to the QIP E Shares. Accordingly, each of QIHMI, QIH Management, SFM and Mr. Soros may be deemed to be beneficial owners of the QIP Shares. Each has their principal office at 888 Seventh Avenue, 33rd Floor, New York, New York 10106. The foregoing information was derived, in part, from certain publicly available reports, statements and schedules filed with the Commission.

- (5) Represents both (i) 31.7 shares of Series E Preferred Stock held in the

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name of SFMDI (the "SFMDI E Shares") and (ii) the QIP E Shares referenced in Note 4 above. As managing member of SFMDI, Mr. Soros also may be deemed the beneficial owner of the SFMDI E Shares. The principal office of SFMDI is at 888 Seventh Avenue, 33rd Floor, New York, New York 10106.

- (6) See "Risk Factors - Change of Control Covenant and Liquidation Preference of Preferred Stock."

### SERIES F PREFERRED STOCK

The following table sets forth certain information with respect to the beneficial ownership of the Series F Preferred Stock of the Company as of February 17, 2006, for (i) each person who is known by the Company to own beneficially more than 5% of the Series F Preferred Stock of the Company, (ii) each of the Company's directors, (iii) the Named Executives, and (iv) all directors and executive officers as a group.

| NAME (1)  | NUMBER OF SHARES<br>BENEFICIALLY OWNED | PERCENTAGE (2) |
|---|--|----------------|
| Patrick C. Barry  | -                                      | -              |
| Barry Erdos   | -                                      | -              |
| Ann Jackson   | -                                      | -              |
| Alan Kane   | -                                      | -              |
| Martin Keane  | -                                      | -              |
| Bradford Matson   | -                                      | -              |
| Martin Miller   | -                                      | -              |
| Neal Moszkowski (3)   | -                                      | -              |
| Christopher G. McCann   | -                                      | -              |
| Melissa Payner-Gregor   | -                                      | -              |
| David Wassong (3)   | -                                      | -              |
| JGB Capital, L.P. (4)   | 284.6                                  | 6.9%           |
| Crescent International Ltd. (5)                                 | 285.7                                  | 6.9%           |
| Portside Growth and Opportunity Fund(6)                         | 571.4                                  | 13.8%          |
| Quantum Industrial Partners LDC                                 | 2,904.6 (7) (9)                        | 70.13%         |
| George Soros  | 3,000 (8) (9)                          | 72.43%         |
| All directors and executive officers as<br>a group (10 persons) | -                                      | -              |

\*Less than 1%.

- (1) Except as otherwise indicated, the address of each of the individuals listed is c/o Bluefly, Inc., 42 West 39th Street, New York, New York 10018.
- (2) Beneficial ownership is determined in accordance with the rules of the Commission and generally includes voting or investment power with respect to securities. Shares of Common Stock issuable upon the exercise of options or warrants currently exercisable or exercisable within 60 days are deemed outstanding for computing the percentage ownership of the person holding such options or warrants but are not deemed outstanding for computing the percentage ownership of any other person.
- (3) Mr. Moszkowski's address is c/o TowerBrook Capital Partners L.P., 430 Park Avenue New York, New York 10022 and Mr. Wassong's address is c/o Soros Fund Management LLC, 888 Seventh Avenue, 33rd Floor, New York, New York 10106. Messrs. Moszkowski and Wassong are the designees of the holders of the Series A and B Preferred Stock. Messrs. Moszkowski and Wassong disclaim beneficial ownership of the shares of Series F Preferred Stock beneficially owned by George Soros and QIP and none of such shares are included in the table above as being beneficially owned by them.
- (4) Brett Cohen in his capacity as the President of JGB Management, Inc., the

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general partner of JGB Capital, LP, has voting and investment power over such securities.

- (5) Mel Crow and Maxi Brezzi, in their capacity as managers of GreenLight Switzerland SA, the investment advisor to Crescent International Ltd., have voting and investment power over the shares owned by Crescent International Ltd. Messrs. Crow and Brezzi disclaim beneficial ownership of such shares.

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- (6) Ramius Capital Group, LLC ("Ramius Capital") is the investment advisor of Portside Growth and Opportunity Fund ("Portside") and consequently has voting and investment power over securities held by Portside. Ramius Capital disclaims beneficial ownership of the shares held by Portside. Peter A. Cohen, Morgan B. Stark, Thomas W. Strauss and Jeffrey M. Solomon are the sole managing members of C4S & Co., LLC, the sole managing member of Ramius Capital. As a result, Messrs. Cohen, Stark, Strauss and Solomon may be considered beneficial owners of any shares deemed to be beneficially owned by Ramius Capital. Messrs. Cohen, Stark, Strauss and Solomon disclaim beneficial ownership of these shares.
- (7) Represents the shares of Series F Preferred Stock held in the name of QIP (the "QIP E Shares"). QIP is an exempted limited duration company formed under the laws of the Cayman Islands, with its principal address at Kaya Flamboyen 9, Willemstad, Curacao, Netherlands Antilles. QIHMI, an investment advisory firm organized as a Delaware limited partnership, is a minority shareholder of, and is vested with investment discretion with respect to portfolio assets held for the account of QIP. The sole general partner of QIHMI is QIH Management. SFM is the sole managing member of QIH Management. Mr. Soros, as Chairman of SFM, may be deemed to have shared voting power and sole investment power with respect to the QIP F Shares. Accordingly, each of QIHMI, QIH Management, SFM and Mr. Soros may be deemed to be beneficial owners of the QIP Shares. Each has their principal office at 888 Seventh Avenue, 33rd Floor, New York, New York 10106. The foregoing information was derived, in part, from certain publicly available reports, statements and schedules filed with the Commission.
- (8) Represents both (i) 95.4 shares of Series F Preferred Stock held in the name of SFMDI (the "SFMDI F Shares") and (ii) the QIP F Shares referenced in Note 4 above. As managing member of SFMDI, Mr. Soros also may be deemed the beneficial owner of the SFMDI F Shares. The principal office of SFMDI is at 888 Seventh Avenue, 33rd Floor, New York, New York 10106.
- (9) See "Risk Factors - Change of Control Covenant and Liquidation Preference of Preferred Stock."

SECURITIES AUTHORIZED FOR ISSUANCE UNDER EQUITY COMPENSATION PLANS

EQUITY COMPENSATION PLAN INFORMATION (AS OF DECEMBER 31, 2005)

| PLAN CATEGORY   | NUMBER OF SECURITIES TO BE<br>ISSUED UPON EXERCISE OF<br>OUTSTANDING OPTIONS,<br>WARRANTS AND RIGHTS (A) | WEIGHTED-AVERAGE EXERCISE<br>PRICE OF OUTSTANDING<br>OPTIONS, WARRANTS AND<br>RIGHTS (B) | NUMBER OF<br>REMAINING<br>FUTURE<br>EQUITY<br>(EXCLUDING<br>REFLECTED<br>(C) |
|---|--|--|--|
| Equity compensation plans<br>approved by security holders | 7,503,912  | \$ 2.01  |  |
| Equity compensation plans not                             |  |  |  |



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|                              |           |         |
|------------------------------|-----------|---------|
| approved by security holders | 534,616   | \$ 1.49 |
| Total                        | 8,038,528 | \$ 1.97 |

The following is a summary of the material provisions of the Bluefly, Inc. 2000 Stock Option Plan (the "2000 Plan"), our only equity compensation plan that has not been approved by our stockholders:

**Eligibility.** Key employees of the Company who are not officers or directors of the Company and its affiliates and consultants to the Company are eligible to be granted options.

**Administration of the Plans.** The Option Plan/Compensation Committee administers the 2000 Plan. The Option Plan/Compensation Committee has the full power and authority, subject to the provisions of the 2000 Plan, to designate

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participants, grant options and determine the terms of all options. The 2000 Plan provides that no participant may be granted options to purchase more than 1,000,000 shares of Common Stock in a fiscal year. The Option Plan/Compensation Committee is required to make adjustments with respect to options granted under the 2000 Plan in order to prevent dilution or expansion of the rights of any holder. The 2000 Plan requires that the Option Plan/Compensation Committee be composed of at least two directors.

**Amendment.** The 2000 Plan may be wholly or partially amended or otherwise modified, suspended or terminated at any time or from time to time by the Board of Directors, but no amendment without the approval of our stockholders shall be made if stockholder approval would be required under any law or rule of any governmental authority, stock exchange or other self-regulatory organization to which we are subject. Neither the amendment, suspension or termination of the 2000 Plan shall, without the consent of the holder of an option under the 2000 Plan, alter or impair any rights or obligations under any option theretofore granted.

**Options Issued Under the 2000 Plan.** The Option Plan/Compensation Committee determines the term and exercise price of each option under the 2000 Plan and the time or times at which such option may be exercised in whole or in part, and the method or methods by which, and the form or forms in which, payment of the exercise price may be paid.

Upon the exercise of an option under the 2000 Plan, the option holder shall pay us the exercise price plus the amount of the required federal and state withholding taxes, if any. The 2000 Plan also allows participants to elect to have shares withheld upon exercise for the payment of withholding taxes.

The unexercised portion of any option granted to a key employee under the 2000 Plan generally will be terminated (i) 30 days after the date on which the optionee's employment is terminated for any reason other than (a) Cause (as defined in the 2000 Plan), (b) retirement or mental or physical disability, or (c) death; (ii) immediately upon the termination of the optionee's employment for Cause; (iii) three months after the date on which the optionee's employment is terminated by reason of retirement or mental or physical disability; or (iv) (A) 12 months after the date on which the optionee's employment is terminated by reason of his death or (B) three months after the date on which the optionee shall die if such death occurs during the three-month period following the termination of the optionee's employment by reason of retirement or mental or physical disability. The Option Plan/Compensation Committee has in the past, and may in the future, extend the period of time during which an optionee may

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exercise options following the termination of his or her employment.

Under the 2000 Plan, an option generally may not be transferred by the optionee other than by will or by the laws of descent and distribution. During the lifetime of an optionee, an option under the 2000 Plan may be exercised only by the optionee or, in certain instances, by the optionee's guardian or legal representative, if any.

### ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

#### EXTENSION OF MATURITY DATES OF NOTES

In February 2006, Soros agreed to extend the maturity dates on the Convertible Promissory Notes issued to affiliates of Soros in July and October 2003. The maturity dates of the Notes, which were originally January and April 2004, respectively, were each extended for one year, from May 1, 2006 to May 1, 2007.

#### TRANSACTIONS WITH SOROS RELATING TO THE LOAN FACILITY

Our Credit Facility with Wells Fargo is secured by a lien on all of the Company's assets, as well as a \$2,000,000 letter of credit issued by Soros in favor of Wells Fargo (the "Soros LC"). Availability under the Credit Facility is determined by a formula that takes into account the amount of the Company's inventory and accounts receivable, as well as the Soros LC.

We are required to pay Soros Fund Management LLC an annual fee in connection with the issuance and maintenance of the Soros LC in an amount equal to the fee that we would be required to pay in order to have a similar letter of credit issued under the Credit Facility. For the year beginning on the date of the closing of the Credit Facility this formula requires an annual fee of \$55,000. We are also required to reimburse Soros for any costs and expenses associated with the issuance and maintenance of the Soros LC.

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### ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

#### AUDIT FEES

The aggregate fees billed for professional services rendered by PricewaterhouseCoopers, LLP ("PwC"), our independent registered public accounting firm, for the audit of our consolidated financial statements, including the reviews of our condensed consolidated financial statements included in our quarterly reports on Form 10-Q, for fiscal 2005 and 2004 were approximately \$175,400 and \$148,500, respectively. In addition, we paid PwC approximately \$25,000 in connection with professional services rendered to us in connection with the filing of our registration statements on Forms S-3 and S-8 in 2005. All of the foregoing services rendered by PwC were pre-approved by the Audit Committee.

#### AUDIT RELATED FEES

Other than the fees described under the caption "Audit Fees" above, PwC did not bill us any fees for services rendered to us during fiscal 2005 and 2004 for assurance and related services in connection with the audit or review of our consolidated financial statements.

#### TAX FEES

PwC did not bill us for any professional services rendered to us during fiscal 2005 and 2004 for tax compliance, tax advice or tax planning.

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## OTHER FEES

PwC did not bill us for any other professional services rendered during fiscal 2005 and 2004 other than those described under the caption "Audit Fees."

## AUDIT COMMITTEE PRE-APPROVAL POLICIES

Our policy is that, before PwC is engaged by us to render audit or non-audit services, the engagement is approved by the Audit Committee. The Audit Committee has delegated its Chairman, Barry Erdos, to approve non-audit services up to \$15,000 on behalf of the Committee.

## ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

### 1. Financial Statements:

Report of Independent Registered Public Accounting Firm  
Consolidated Balance Sheets as of December 31, 2005 and 2004  
Consolidated Statements of Operations for the three years ended December 31, 2005, 2004 and 2003  
Consolidated Statements of Changes in Shareholders' Equity for the three years ended December 31, 2005, 2004 and 2003  
Consolidated Statements of Cash Flows for the three years ended December 31, 2005, 2004 and 2003  
Notes to Consolidated Financial Statements

### 2. Financial Statement Schedules:

Schedule II - Valuation and Qualifying Accounts

### 3. Exhibits:

| EXHIBIT NO. | DESCRIPTION   |
|-------------|---|
| 3.1 (f)     | Certificate of Incorporation of the Company.  |
| 3.2 (f)     | By-Laws of the Company.   |
| 3.3 (i)     | Certificate of Powers, Designations, Preferences and Rights of Series C Preferred Stock of the Company.   |
| 3.4 (j)     | Certificate of Powers, Designations, Preferences and Rights of Series D Preferred Stock of the Company.   |
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| 3.5 (k)     | Certificate of Powers, Designations, Preferences and Rights of Series E Preferred Stock of the Company.   |
| 3.6 (v)     | Certificate of Powers, Designations, Preferences and rights of Series F Preferred Stock of the Company.   |
| 10.1 (c)    | Amended and Restated 1997 Stock Option Plan.  |
| 10.2 (a)    | Lease Agreement by and between the Company and John R. Perlman, et al., dated as of May 5, 1997.  |
| 10.3 (b)    | Investment Agreement among the Company, Quantum Industrial Partners LDC, SFM Domestic Investments LLC and Pilot Capital Corp., dated July 27, 1999. |

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- 10.4 (b) Lease by and between the Company and Adams & Co. Real Estate, Inc., dated March 22, 1999.
- 10.5 (c) Note and Warrant Purchase Agreement, dated as of March 28, 2000, by and among the Company, Quantum Industrial Partners LDC and SFM Domestic Investments LLC.
- 10.6 (d) Lease by and between the Company and Adams & Co. Real Estate, Inc., dated May 4, 2000.
- 10.7 (d) Note and Warrant Purchase Agreement, dated as of May 16, 2000, by and among the Company, Quantum Industrial Partners LDC and SFM Domestic Investments LLC.
- 10.8 (d) Note and Warrant Purchase Agreement, dated as of June 28, 2000, by and among the Company, Quantum Industrial Partners LDC and SFM Domestic Investments LLC.
- 10.9 (e) Bluefly, Inc. 2000 Stock Option Plan.
- 10.10 (e) Note and Warrant Purchase Agreement, dated as of August 21, 2000, by and among the Company, Quantum Industrial Partners LDC and SFM Domestic Investments LLC.
- 10.11 (e) Note and Warrant Purchase Agreement, dated as of October 2, 2000, by and among the Company, Quantum Industrial Partners LDC and SFM Domestic Investments LLC.
- 10.12 (e) Investment Agreement, dated November 13, 2000, by and among the Company, Bluefly Merger Sub, Inc., Quantum Industrial Partners LDC and SFM Domestic Investments LLC.
- 10.13 (f) Warrant, dated March 30, 2001, issued to Quantum Industrial Partners LDC.
- 10.14 (f) Warrant, dated March 30, 2001, issued to SFM Domestic Investments LLC.
- \*10.15 (g) Software License and Services Agreement, dated March 12, 2002, by and among the Company and Blue Martini Software, Inc.
- 10.16 (g) Warrant No. 1 dated March 27, 2002, issued to Quantum Industrial Partners LDC.
- 10.17 (g) Warrant No. 2 dated March 27, 2002, issued to SFM Domestic Investments LLC.
- 10.18 (g) Warrant No. 3 dated March 30, 2002, issued to Quantum Industrial Partners LDC.
- 10.19 (g) Warrant No. 4 dated March 30, 2002, issued to SFM Domestic Investments LLC.
- 10.20 (h) Common Stock and Warrant Purchase Agreement, dated May 24, 2002, by and between the Registrant and the investors listed on Schedule 1 thereto.
- 10.21 (i) Series C Preferred Stock and Note Purchase Agreement, dated September 27, 2002, by and between the Registrant and the investors listed on Schedule 1 thereto.

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- 10.22 (j) Employment Agreement, dated as of July 31, 2002, by and between the Company and Patrick Barry.
- 10.23 (j) Note and Warrant Purchase Agreement, dated January 28, 2003, by and between the Registrant and the investors listed on Schedule 1 thereto.
- 10.24 (j) Warrant No. 1 dated January 28, 2003, issued to Quantum Industrial Partners LDC.
- 10.25 (j) Warrant No. 2 dated January 28, 2003, issued to SFM Domestic Investments LLC.
- 10.26 (j) Series D Preferred Stock Purchase Agreement, dated March 12, 2003, by and between the Registrant and the investors listed on Schedule 1 thereto.

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- 10.27 (j) Warrant No. 4 dated March 17, 2003, issued to Quantum Industrial Partners LDC.
- 10.28 (j) Warrant No. 5 dated March 17, 2003, issued to SFM Domestic Investments LLC.
- 10.29 (k) Series E Preferred Stock Purchase Agreement, dated May 21, 2003, by and between the Registrant and the investors listed on Schedule 1 thereto.
- 10.20 (l) Note Purchase Agreement, dated as of July 16, 2003, by and between the Registrant and the investors listed on Schedule 1 thereto.
- 10.31 (l) Demand Promissory Note, dated as of July 16, 2003, issued to Quantum Industrial Partners LDC.
- 10.32 (l) Demand Promissory Note, dated as of July 16, 2003, issued to SFM Domestic Investments LLC.
- 10.33 (m) Note Purchase Agreement, dated as of October 17, 2003, by and between the Registrant and the investors listed on Schedule 1 thereto.
- 10.34 (m) Demand Promissory Note, dated as of October 17, 2003, issued to Quantum Industrial Partners LDC.
- 10.35 (m) Demand Promissory Note, dated as of October 17, 2003, issued to SFM Domestic Investments LLC.
- 10.36 (n) Employment Agreement dated as of September 22, 2003 by and between Bluefly, Inc. and Melissa Payner-Gregor.
- 10.37 (o) Common Stock and Warrant Purchase Agreement dated January 9, 2004 by and among the Company and the Investors listed on Schedule 1 thereto.
- 10.38 (p) Amendment to Promissory Notes, dated as of January 12, 2004, by and among the Company, Quantum Industrial Partners LDC and SFM Domestic Investments LLC.
- \*10.39 (q) CallTech Master Agreement for Outsourcing Contact Center Support,

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dated as of August 5, 2004, by and between the Registrant and CallTech Communications, LLC.

- 10.40 (r) Amendment to Promissory Notes, dated as of February 18, 2005, by and among the Company, Quantum Industrial Partners LDC and SFM Domestic Investments LLC.
- 10.41 (s) Bluefly, Inc. 2005 Stock Incentive Plan.
- \*10.42 (t) Master Service Agreement, dated as of February 28, 2005, by and between the Company and Level 3 Communications, LLC.
- \*10.43 (t) Customer Order Addendum, dated as of February 28, 2005, by and between the Company and Level 3 Communications, LLC.
- \*10.44 (u) Master Services Agreement, dated as of March 21, 2005, by and between the Company and NewRoads, Inc.
- \*10.45 (u) Statement of Work 1 by and between the Company and NewRoads, Inc.
- 10.46 (v) Preferred Stock and Warrant Purchase Agreement, dated as of June 24, 2005, by and among the Company and the Investors listed on the signature page thereto.
- 10.47 (w) Loan and Security Agreement, dated July 26, 2005, by and between the Company and Wells Fargo Retail Finance, LLC.
- 10.48 (w) Reimbursement Agreement, dated July 26, 2005, by and among the Company, Quantum Industrial Partners LDC and Soros Fund Management, LLC.

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- 10.49 (w) Fee Letter, dated July 26, 2005, by and between the Company and Soros Fund Management, LLC.
- 10.50 (x) Employment Agreement, dated as of September 19, 2005, by and between the Company and Bradford Matson.
- 10.51 (y) Amendment to Promissory Notes, dated as of February 17, 2006, by and among the Company, Quantum Industrial Partners LDC and SFM Domestic Investments LLC.
- 21.1 Subsidiaries of the Registrant.
- 23.1 Consent of PricewaterhouseCoopers LLP.
- 31.1 Certification Pursuant to Rule 13a-14(a)/15d-14(a).
- 31.2 Certification Pursuant to Rule 13a-14(a)/15d-14(a).
- 32.1 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\* Confidential treatment requested as to certain portions of this Exhibit. Such portions have been redacted.

(a) Incorporated by reference to the Company's Quarterly report filed on

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- Form 10-QSB for the quarterly period ended March 31, 1997.
- (b) Incorporated by reference to the Company's Quarterly report filed on Form 10-QSB for the quarterly period ended June 30, 1999.
  - (c) Incorporated by reference to the Company's Annual report filed on Form 10-KSB for the year ended December 31, 1999.
  - (d) Incorporated by reference to the Company's Quarterly report filed on Form 10-Q for the quarterly period ended June 30, 2000.
  - (e) Incorporated by reference to the Company's Quarterly report filed on Form 10-Q for the quarterly period ended September 30, 2000.
  - (f) Incorporated by reference to the Company's Annual report filed on Form 10-K for the year ended December 31, 2000.
  - (g) Incorporated by reference to the Company's Annual report filed on Form 10-K for the year ended December 31, 2001.
  - (h) Incorporated by reference to the Company's Quarterly report filed on Form 10-Q for the quarterly period ended June 30, 2002.
  - (i) Incorporated by reference to the Company's current report on Form 8-K, dated October 1, 2002.
  - (j) Incorporated by reference to the Company's Annual Report filed on Form 10-K for the year ended December 31, 2002.
  - (k) Incorporated by reference to the Company's Quarterly report filed on Form 10-Q for the quarterly period ended June 30, 2003.
  - (l) Incorporated by reference to the Company's report on Form 8-K, dated July 17, 2003.
  - (m) Incorporated by reference to the Company's report on Form 8-K, dated October 20, 2003.
  - (n) Incorporated by reference to the Company's Quarterly report filed on Form 10-Q for the quarterly period ended September 30, 2003.
  - (o) Incorporated by reference to the Company's report on Form 8-K, dated January 13, 2004.
  - (p) Incorporated by reference to the Company's report on Form 8-K, dated January 16, 2004.
  - (q) Incorporated by reference to the Company's quarterly report on Form 10-Q for the quarterly period ended June 30, 2004.
  - (r) Incorporated by reference to the Company's report on Form 8-K, dated February 22, 2005.
  - (s) Incorporated by reference to the Company's annual report on Form 10-K for the year ended December 31, 2005.
  - (t) Incorporated by reference to the Company's report on Form 8-K, dated March 4, 2005.
  - (u) Incorporated by reference to the Company's report on Form 8-K, dated March 23, 2005.
  - (v) Incorporated by reference to the Company's report on Form 8-K, dated June 28, 2005.
  - (w) Incorporated by reference to the Company's report on Form 8-K, dated July 29, 2005.
  - (x) Incorporated by reference to the Company's report on Form 8-K, dated September 22, 2005.
  - (y) Incorporated by reference to the Company's report on Form 8-K, dated February 21, 2006.

\* Confidential treatment has been requested as to certain portions of this Exhibit. Such portions have been redacted.

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### SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

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BLUEFLY, INC.

By: /s/ Melissa Payner-Gregor

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Melissa Payner-Gregor  
Chief Executive Officer and President

February 28, 2006

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

| SIGNATURE  | TITLE  | DATE              |
|--|--|-------------------|
| -----<br>/s/ Alan Kane<br>-----<br>Alan Kane                         | Chairman of the Board  | February 28, 2006 |
| -----<br>/s/ Melissa Payner-Gregor<br>-----<br>Melissa Payner-Gregor | Chief Executive Officer<br>(Principal Executive Officer),<br>President and Director      | February 28, 2006 |
| -----<br>/s/ Patrick C. Barry<br>-----<br>Patrick C. Barry           | Chief Financial Officer and<br>Chief Operating Officer<br>(Principal Accounting Officer) | February 28, 2006 |
| -----<br>/s/ Barry Erdos<br>-----<br>Barry Erdos                     | Director   | February 28, 2006 |
| -----<br>/s/ Ann Jackson<br>-----<br>Ann Jackson                     | Director   | February 28, 2006 |
| -----<br>/s/ Martin Miller<br>-----<br>Martin Miller                 | Director   | February 28, 2006 |
| -----<br>/s/ Neal Moszkowski<br>-----<br>Neal Moszkowski             | Director   | February 28, 2006 |
| -----<br>/s/Christopher McCann<br>-----<br>Christopher McCann        | Director   | February 28, 2006 |
| -----<br>/s/ David Wassong<br>-----<br>David Wassong                 | Director   | February 28, 2006 |