North Atlantic Holding Company, Inc.
Form 10-K
March 30, 2007
Table of Contents

# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, D.C. 20549**

# FORM 10-K

**FOR ANNUAL AND TRANSITION REPORTS**

**PURSUANT TO SECTIONS 13 OR 15(d) OF THE**

**SECURITIES EXCHANGE ACT OF 1934**

**(Mark One)**

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
**For the fiscal year ended December 31, 2006**

**OR**

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
**For the transition period from ______ to______**

**Commission File Number 333-115587**

# NORTH ATLANTIC HOLDING COMPANY, INC.

**(Exact name of registrant as specified in its charter)**

| **Delaware** | **20-0709285** |
|---|---|
| **(State or other jurisdiction of incorporation or organization)** | **(I.R.S. Employer Identification No.)** |

**3029 WEST MUHAMMAD ALI BOULEVARD, LOUISVILLE, KENTUCKY 40212**

**(Address of principal executive offices) (Zip Code)**

**Registrant s telephone number, including area code: (502) 778-4421**

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

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

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

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

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

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

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

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer x.

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

As of June 30, 2006, the only class of voting or non-voting common equity issued and outstanding was the Registrant s Voting Common Stock, par value $.01 per share. There is no trading market for the Voting Common Stock. As of March 27, 2007, 699,589 shares of the Registrant s Voting Common Stock, par value $.01 per share, were outstanding.

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**Table of Contents**

North Atlantic Holding Company, Inc.

2006 Annual Report on Form 10-K

TABLE OF CONTENTS


| | | Page |
|---|---|---|
| | PART I | |
| Item 1. | Business | 1 |
| Item 1A. | Risk Factors | 17 |
| Item 1B. | Unresolved Staff Comments | 25 |
| Item 2. | Properties | 25 |
| Item 3. | Legal Proceedings | 26 |
| Item 4. | Submission of Matters to a Vote of Security Holders | 31 |
| | PART II | |
| Item 5. | Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities | 31 |
| Item 6. | Selected Financial Data | 31 |
| Item 7. | Management s Discussion and Analysis of Financial Condition and Results of Operations | 33 |
| Item 7A. | Quantitative and Qualitative Disclosures About Market Risk | 41 |
| Item 8. | Financial Statements and Supplementary Data | 42 |
| Item 9. | Changes in and Disagreements With Accountants on Accounting and Financial Disclosure | 42 |
| Item 9A. | Controls and Procedures | 42 |
| Item 9B. | Other Information | 43 |
| | PART III | |
| Item 10. | Directors, Executive Officers and Corporate Governance | 43 |
| Item 11. | Executive Compensation | 46 |
| Item 12. | Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters | 60 |
| Item 13. | Certain Relationships and Related Transactions, and Director Independence | 62 |
| Item 14. | Principal Accountant Fees and Services | 65 |
| | PART IV | |
| Item 15. | Exhibits and Financial Statement Schedules | 67 |
| SIGNATURES | | 75 |

Table of Contents

# PART I

## Item 1. Business

### Overview

North Atlantic Holding Company, Inc. (the Company ) is a holding company which owns North Atlantic Trading Company, Inc. ( NATC ) and its subsidiaries, National Tobacco Company, L.P. ( NTC ), North Atlantic Operating Company, Inc. ( NAOC ), North Atlantic Cigarette Company, Inc. ( NACC ), National Tobacco Finance Corporation, Fred Stoker & Sons, Inc., RBJ Sales, Inc. and Stoker, Inc. (collectively, Stoker ). Except where the context otherwise requires, references to the Company include the Company and its subsidiaries. NTC is the third largest manufacturer and marketer of loose leaf chewing tobacco in the United States, selling its products under the ***Beech-Nut***®, ***Trophy***®, ***Havana Blossom***®, ***Durango***®, ***Stoker***, ***Our Pride***, and other brand names. NTC also manufactures and markets **ZIG-ZAG** Premium Cigarettes. NTC also packages and markets its cigarette tobacco brands ***Stokers No. 2*** and ***Old Hillside***, among other brands, and also packages and markets for NAOC on a contract basis ***Zig-Zag*** cigarette tobacco. NAOC is the largest importer and distributor in the United States of premium cigarette papers and related products, which are sold under the ***ZIG-ZAG***® brand name pursuant to an exclusive long-term distribution agreement with Bolloré, S.A.

### Evolution of the Company

The Company s principal executive offices are located at 3029 West Muhammad Ali Boulevard, Louisville, Kentucky 40212, and its telephone number is (502) 778-4421.

In 1988, Thomas F. Helms, Jr., Executive Chairman of the Company, and an investor group led by Lehman Brothers formed NTC to acquire the smokeless tobacco division of Lorillard Tobacco Company ( Lorillard ). Lorillard had manufactured and sold the popular ***Beech-Nut*** brand of loose leaf chewing tobacco since 1897.

In 1997, NATC was formed to facilitate a corporate reorganization undertaken in connection with the acquisition (the 1997 Acquisition ) of NATC Holdings USA, Inc., which owned the exclusive rights to market and distribute ***ZIG-ZAG*** premium cigarette papers in the United States, Canada and certain other international markets. Upon consummation of the 1997 Acquisition and the related reorganization, NATC became the holding company of NTC, which operates the Company s smokeless tobacco business, and NAOC, which operates the Company s premium cigarette paper and MYO cigarette business.

On November 17, 2003, NATC consummated the acquisition of Stoker. Through the acquisition, NATC acquired the Stoker family of brands and the related business operations, including the equipment used to manufacture and package the Stoker products. The Stoker family consists of loose leaf chewing tobacco products and MYO tobacco and related products, as well as a number of moist snuff and pipe tobacco brands. NATC also acquired the Stoker catalog business which principally sells tobacco products.

Effective as of February 9, 2004, NATC consummated a holding company reorganization, whereby the Company became the parent company of NATC. The holding company reorganization was consummated in part to allow the Company to issue senior discount notes in connection with NATC s refinancing of its existing debt and preferred stock, as more fully discussed below.

The holding company reorganization was effected pursuant to an Agreement and Plan of Merger (the Merger Agreement ), dated as of February 9, 2004, among NATC, the Company and NATC Merger Sub, Inc., a Delaware corporation and direct wholly-owned subsidiary of the Company ( Merger Sub ). The Merger Agreement provided for, among other things, the merger of Merger Sub with and into NATC, with NATC being the surviving corporation (the Merger ). In accordance with Section 228(a) of the Delaware General Corporation Law, NATC received the required written approval of the Merger by the holders of a majority of the outstanding shares of NATC s voting common stock.

As a result of the Merger, (i) NATC became a direct, wholly-owned subsidiary of the Company; (ii) each issued and outstanding share of NATC Stock, was converted into the right to receive one share of common stock of the Company, par value $0.01 per share ( Company Common Stock ); (iii) each issued and outstanding share of common stock of Merger Sub was converted into one issued and outstanding share of common stock of NATC and Merger Sub ceased to exist; and (iv) all of the issued and outstanding shares of Company Common Stock held by NATC were cancelled.

In connection with the Merger, the Company assumed all of NATC s obligations under NATC s outstanding warrants and stock options which were converted into rights to purchase an identical number of shares of Company Common Stock. The subsidiaries of the Company were unaffected by the reorganization.

1

**Table of Contents**

On February 17, 2004, NATC consummated the refinancing of its existing debt and preferred stock, as well as a general corporate reorganization. The refinancing consisted principally of (1) the offering and sale of $200.0 million principal amount of senior notes by NATC, (2) NATC entering into an amended and restated loan agreement that provided a $50.0 million senior secured revolving credit facility and (3) the concurrent offering and sale of $97.0 million aggregate principal amount at maturity of senior discount notes of the Company. Both the senior notes and the senior discount notes were offered pursuant to Rule 144A and Regulation S under the Securities Act of 1933, as amended.

Concurrently with the closing of the refinancing, NATC also called for redemption all of its outstanding 11% senior notes due 2004, in accordance with the terms of the indenture governing such notes, at the applicable redemption price of 100.0% of the principal amount thereof, plus interest accrued to the redemption date of April 2, 2004.

On March 18, 2004, NATC redeemed all outstanding shares of its 12% senior exchange payment-in-kind preferred stock, at the applicable redemption price equal to the liquidation preference of the preferred stock ($22.00 per share), plus an amount in cash equal to all accumulated and unpaid dividends.

On January 19, 2005, the Company engaged the firm of Alvarez & Marsal, LLC ( A&M ), a global professional services firm specializing in providing interim senior management, restructuring and corporate advisory services, and appointed Mr. Douglas P. Rosefsky, a Managing Director of A&M, as Interim Chief Financial Officer upon the resignation of the Company s former Chief Financial Officer. On April 11, 2005, Mr. Brian C. Harriss was appointed Senior Vice President and Chief Financial Officer of the Company, replacing Mr. Rosefsky, and Mr. Rosefsky was appointed President and Chief Executive Officer of the Company, replacing Thomas F. Helms, Jr. Mr. Helms continued as Executive Chairman of the Company, focusing on the Company s general business strategies, strategic alliances, joint ventures, acquisitions and licensing arrangements. On June 8, 2005, shortly after Mr. Robert Milliken, Jr. resigned from the positions of President and Chief Operating Officer of NTC and NAOC, Mr. Lawrence S. Wexler, who had previously served as President and Chief Operating Officer of NACC, was appointed Chief Operating Officer of the Company overseeing all marketing, sales, customer service and manufacturing functions in the Company and its operating subsidiaries.

On June 16, 2005, NATC refinanced its existing $35.0 million Amended and Restated Loan Agreement, dated as of February 17, 2004, by and among JP Morgan Chase Bank, N.A., as agent, the Company, NATC and its subsidiaries by entering into a Financing Agreement (the Financing Agreement ) among the Company, NATC and its subsidiaries, the financial institutions from time to time party thereto as lenders, and Fortress Credit Corp., as agent for the Lenders. The Financing Agreement consists of a $30.0 million term loan facility and a $55.0 million revolving credit facility, and includes a letter of credit sublimit of $10.0 million (collectively, the Credit Facility ). The Credit Facility will mature on June 30, 2010, and does not provide for any amortization of the term loan prior to maturity. NATC and its subsidiaries will use the revolving credit facility for working capital requirements and other general corporate purposes.

On October 1, 2006, NATC and the Company (collectively, the Companies ) retained Lazard Frères & Co. LLC ( Lazard ) as the Companies financial advisor to assist the Companies in exploring and evaluating potential alternatives relating to a financial recapitalization of the Companies. In consultation with Lazard, the Companies considered various recapitalization alternatives, including an exchange (the Exchange Transaction ) of the Company s outstanding 12.25% Senior Discount Notes due 2014 (the Senior Discount Notes ), which were issued pursuant to that certain Indenture, dated as of February 17, 2004, between the Company and Wells Fargo Bank Minnesota, National Association, a national banking association ( Wells Fargo ), as Indenture Trustee, and a majority of NATC s outstanding 9.25% Senior Notes due 2012 (the Senior Notes ), which were issued pursuant to that certain Indenture, dated as of February 17, 2004, among NATC, the guarantors listed on the signature pages thereto and Wells Fargo, as Indenture Trustee, for new second lien secured notes of the Company (the Second Lien Notes ).

The Companies, with the assistance of Lazard, have held discussions with various holders of Senior Discount Notes and Senior Notes regarding the Exchange Transaction. As of the date of this filing, holders of 76.9% of the aggregate amount outstanding of the Senior Discount Notes and 54.84% of the aggregate amount outstanding of the Senior Notes have entered into written agreements in principle to participate in the Exchange Transaction on substantially the terms set forth in the Indicative Summary of Terms and Conditions (the Term Sheet ), which was filed as Exhibit 99.1 to the Registrant s Current Report on Form 8-K filed on March 21, 2007. The exchange ratio would be $950 principal amount and $812.50 principal amount of Second Lien Notes for each $1,000 principal amount of Senior Notes and Senior Discount Notes, respectively. The Exchange Transaction would be offered to the holders of at least a majority and up to 100% of the outstanding Senior Discount Notes and to certain holders of at least a majority and up to 55% of the outstanding Senior Notes. As part of the Exchange Transaction, the existing Indentures for the Senior Discount Notes and Senior Notes would be amended to eliminate many of the covenants and events of default contained therein. The Companies obligations to file reports with the Securities and Exchange Commission would terminate if the Exchange Transaction is consummated, although it would continue to make its financial statements and certain other information available to the indenture trustee for the Second Lien

2

Table of Contents

Notes and on a password protected website. The foregoing discussion of the Exchange Transaction and the Term Sheet is qualified in its entirety by reference to the full text of the Term Sheet, which was filed on March 21, 2007 as Exhibit 99.1 to the Registrant s Current Report on Form 8-K and is incorporated herein by reference. There can be no assurance, however, that this process will result in a definitive transaction, or as to the final terms thereof, or any other recapitalization transaction by the Companies. Any offering or issuance of the Second Lien Notes will not be and have not been registered under the Securities Act of 1933, as amended, and may not be offered or sold in the United States absent registration under, or an applicable exemption from the registration requirements of, such Act.

**Business Strategy**

The Company s business strategy is to grow, both internally and through acquisitions, by responsibly marketing its products to adult consumers and by complying with all applicable laws, regulations and statutes. The Company intends to (i) capitalize on the strong brand identities of its products with a focus on product linkages and extensions; and (ii) improve the sales, marketing and operating efficiencies of its subsidiaries. Through the elimination or reduction of certain administrative costs, the achievement of certain manufacturing efficiencies and through growth in distribution, the Company seeks to increase its sales and cash flows. In addition, the Company has strategies for each of its product groups that are designed to maintain and improve their profitability.

*Expand the Company s leadership position in the premium cigarette papers business*. Building upon its exclusive long-term distribution and license agreement with Bolloré in the United States and Canada, the Company seeks to expand its ***ZIG-ZAG*** premium cigarette papers brand. The Company is focused on increasing the distribution of its existing lines of premium cigarette papers products in underserved channels and markets.

*Enhance the profit contribution of the Company s loose leaf chewing tobacco segment*. Historically, the Company has maintained the profit contribution of its loose leaf chewing tobacco segment by offsetting volume declines with price increases and by controlling costs. With the addition of products which target the value oriented category of the loose leaf chewing tobacco market, the Company seeks to slow its historical trend of volume declines while expanding sales of value-oriented products by offering them through the Company s distribution network. The Company also expects to further improve profitability through manufacturing cost efficiencies by effecting certain capital expenditures in its manufacturing facility in Louisville, Kentucky.

*Continue to benefit from the growth in the MYO tobacco and related products market*. MYO tobacco and related products currently enjoy a price advantage over manufactured cigarettes, primarily due to a lower level of federal and state excise taxation on MYO tobacco and the higher level of Master Settlement Agreement ( MSA ) compliance costs associated with manufactured cigarettes. Other countries, such as the United Kingdom and Canada, indicate a strong correlation between rising manufactured cigarette prices and increasing consumption of MYO tobacco and related products. In 1999, the Company launched the industry s first fully-integrated MYO line of products, comprised of smoking tobaccos, tubes, injectors and starter kits under the ***ZIG-ZAG*** brand. The Company expanded its portfolio of MYO tobacco and related products by acquiring the Stoker brands. The Company believes its existing portfolio of ***ZIG-ZAG*** premium MYO tobacco and related products, supplemented by the acquired Stoker portfolio of value-oriented MYO tobacco and related products, will allow it to continue to benefit from the growth trend in this market.

*Assess the market opportunities for the Company s **ZIG-ZAG** Premium Cigarette*. During September 2003, the Company began a highly focused launch of a premium manufactured cigarette under the ***ZIG-ZAG*** Premium Cigarette brand. The Company has introduced the product in a number of test markets since this date and is currently assessing its opportunities in the cigarette market.

*Maintain lean, low cost culture*. The Company s most significant cost of goods sold, other than federal excise taxes, are tobacco and packaging. The Company monitors these costs and has relationships with multiple suppliers to maintain competitive pricing. The Company operates an efficient manufacturing operation that currently requires a modest level of capital expenditures. The Company maintains a lean corporate staff and an operating company culture that seeks to minimize the overhead costs associated with its operations.

**Industry and Markets**

The Company currently competes in three distinct markets within the overall tobacco industry: (1) the smokeless tobacco market, which includes loose leaf chewing tobacco; (2) the MYO products market, which is comprised of premium cigarette papers and MYO tobaccos and related products; and (3) the premium cigarette category of the manufactured cigarette market. The Company believes that the tobacco industry is characterized by non-cyclical demand, relative brand loyalty, meaningful barriers to entry, defined channels of distribution, modest capital expenditure requirements, relatively high profit margins, generally stable wholesale prices and the ability to generate consistent free cash flows.

**Table of Contents**

*Smokeless Tobacco*

Smokeless tobacco products, including loose leaf chewing tobacco, have a long, established tradition of use in the United States. An estimated 5.5 million or 3% of adult Americans are regular users of smokeless tobacco products, according to the U.S. Department of Health and Human Services and the 2005 National Household Survey. The smokeless tobacco market is composed of the five product categories listed below:

*Moist Snuff:* Moist snuff made from dark, fire-cured tobacco that is aged, flavored, cut and packaged.

*Loose Leaf Chewing Tobacco:* Loose leaf chewing tobacco is typically made from air-cured leaf tobacco, using both domestic and imported tobaccos, which is aged, flavored and packed in foil pouches.

*Plug Chewing Tobacco:* Plug chewing tobacco is made from air-cured leaf tobacco, which is heavily flavored and pressed into small bricks or blocks.

*Twist Chewing Tobacco:* Twist chewing tobacco is made of dark, air-cured tobacco, which is twisted into strands that are dried and packaged like a dry, pliable rope.

*Dry Snuff:* Dry snuff is a very finely ground, powdered tobacco product, which is sometimes flavored and is packaged in a variety of containers.

The Company believes that many consumers of smokeless tobacco regularly use products in more than one of the aforementioned categories. Further, many of its competitors in the smokeless tobacco market offer products in more than a single smokeless tobacco category. In addition to the Company, other major manufacturers and marketers of smokeless tobacco include US Smokeless Tobacco Co., Swedish Match North America, Inc., the Conwood unit of Reynolds America and Swisher International, Inc.

According to information provided by the former Smokeless Tobacco Council, manufacturers sales for the smokeless tobacco market increased to $2.37 billion in 2005 from $1.7 billion in 1995, representing a 10-year compound annual growth rate of 3.1%. The increase in sales is primarily related to an increase in manufacturers sales of moist snuff, which grew to $1.97 billion in 2005 from $1.3 billion in 1995, representing a 10-year compound annual growth rate of 3.9%. In contrast to the growth of moist snuff sales, there has been a decline in manufacturers sales of chewing tobacco products, including loose leaf chewing tobacco.

Loose leaf chewing tobacco, although a mature product category, remains popular in the Southeast, Southwest, rural Northeast and North Central regions of the United States. Consistent with a general trend in the tobacco industry, however, unit volumes of loose leaf chewing tobacco products have been declining and decreased at a compound annual decline rate of 4% from 1995 to 2005. Manufacturers and marketers of loose leaf chewing tobacco products have partially offset the impact of this decline with increases in the prices of loose leaf chewing tobacco products. While there has been an overall decline in volume, the Company estimates that the volume of sales of the large-sized, value-oriented category of loose leaf chewing tobacco products has grown. Large-sized, value-oriented loose leaf chewing tobacco products are packaged in 8 oz. or 16 oz. bag sizes (as compared to the 3 oz. bag size in which other loose leaf chewing tobacco products are usually sold) and are generally sold at a lower price per ounce of product than other loose leaf chewing tobacco products.

The Company estimates it has a current share of approximately 18% of the loose leaf chewing tobacco market. The other three principal competitors in the loose leaf chewing tobacco product category, together with the Company, represented nearly all of the loose leaf chewing tobacco category in the United States in 2006. The Company s market share and those of its principal competitors in the loose leaf chewing tobacco products market have remained relatively consistent over the past five years, with Swedish Match North America, Inc. holding an approximate 43% market share; the Conwood unit of Reynolds America, an approximate 29% market share; and Swisher International, Inc., an approximate 8% market share.

Loose leaf chewing tobacco products are typically sold through mass merchandisers, chain and independent convenience stores, tobacco outlets, food stores and chain and independent drug stores. Tobacco outlets are becoming an increasingly important distribution channel for all tobacco products, including loose leaf chewing tobacco. Some retailers purchase loose leaf chewing tobacco direct from manufacturers although most

purchase through wholesale distributors.

*MYO Products*

The MYO products market consists of several different product categories, with each product designed to work with the others to allow the consumer to make their own cigarettes. Among the products are premium cigarette papers, MYO tobacco, which is cigarette smoking tobacco in loose form, packaged typically in canisters, pouches or bags, and products relating to MYO tobacco, which include cigarette tubes (papers with a filter fashioned into an empty cigarette), cigarette rolling machines, used to roll cigarette papers and tobacco into a cigarette, and cigarette injector machines, used to insert the smoking tobacco into the empty cigarette tubes.

**Table of Contents**

Premium Cigarette Papers. The production and sale of premium cigarette papers long preceded the invention of machine-made mass manufactured filtered cigarettes and cigarette tubes. Overall market sales of premium cigarette papers have been historically stable and during the past six years have benefited to a slight degree from the increasing growth of MYO tobacco and related products, which has been offset by substitute product offerings.

There are two principal paper categories: premium, interleaved paper and discount flat or non-interleaved paper. Premium cigarette papers are made primarily from rice, flax or combinations of other natural fibers. Characteristics used to distinguish various papers include size, stability and cut, all of which affect the ease of making your own cigarettes, and variations of material and flavor, which impact taste. Premium cigarette papers are sold in interleaved booklets in various sizes and are also segmented by price and quality.

The Company s principal competitors in the premium cigarette paper market are Republic Tobacco L.P., which markets JOB®; Robert Burton Associates, Inc., a wholly-owned subsidiary of Imperial Tobacco Group plc, which markets EZ Wider® and Rizla®; and VCT B.V., which markets the Bambu® brand. While market information is not officially compiled, the Company estimates that it, together with these three companies, collectively have a market share in excess of 98% of the premium cigarette papers market. Premium cigarette papers are typically sold through the following retail distribution channels: convenience stores, chain and independent drug stores, mass merchandisers, food stores and tobacco outlets. Retailers purchase premium cigarette papers primarily from wholesale distributors.

*MYO tobacco and related products.* If viewed as a part of a total cigarette market, which includes both manufactured cigarettes and MYO tobacco and related products, the Company believes that on a cigarette-equivalent basis, aggregate MYO tobacco and related products sales would have represented an estimated U.S. market share of 0.7% in 1998 and 1.8% in 2006, more than doubling its share of the market. Based on MSA calculations, this would equate to an estimated 3.5 billion cigarette equivalents sold in 1998, increasing to an estimated 8.4 billion cigarette equivalents sold in 2006 in the United States.

The MYO tobacco and related products market has been one of the fastest growing markets in the tobacco industry over the past five years. The Company believes this growth has been driven primarily by the increasing price differential between the cost of a consumer making cigarettes using MYO products and the prices of manufactured cigarettes. Manufactured cigarette prices have risen during this period primarily as a result of increased state excise and sales taxes and the pass through by cigarette manufacturers of the cost of complying with the MSA. U.S. growth in sales of MYO tobacco and related products is consistent with sales trends that have occurred for these products in Canada and Europe. For example, in the United Kingdom, following significant increases in specific excise and ad-valorem sales (VAT) taxes on manufactured cigarettes, sales of MYO products on a cigarette-equivalent basis grew from representing 5% of the cigarette market in 1993 to 13% of the market in 2002.

The other principal U.S. competitors in the MYO tobacco and related products market are Republic Tobacco, L.P., and its TOP Tobacco, L.P. subsidiary, which markets the Top® brand; and Lane Limited, a subsidiary of Reynolds America, which markets the Bugler® and Kite® brands. Many other companies also compete in this market, such as Peter Stokkebye International A/S, which markets the Bali Shag® brand through a distribution agreement with Commonwealth Brands, and Santa Fe Natural Tobacco Company Inc., a unit of Reynolds America, which markets the Natural American Spirit® brand.

MYO tobacco and related products are typically sold through mass merchandisers, chain and independent convenience stores, tobacco outlets, food stores and chain and independent drug stores. Some retailers purchase MYO tobacco and related products direct from manufacturers although most purchase through wholesale distributors. MYO tobacco products are subject to escrow deposits as an NPM under the MSA.

*Manufactured Cigarettes*

The U.S. tobacco industry has faced substantial challenges in recent years, including large price increases to pay for litigation, increased federal and state excise taxes, the advent of the MSA, the tobacco quota buyout for farmers, large-scale media campaigns run by anti-smoking groups, increased restrictions on cigarette marketing and a decrease in the number and types of locations where smoking is permitted. Despite these challenges, U.S. cigarette consumption has only declined modestly in recent years. Further, overall industry dollar sales have grown due to strong price increases and the ability to pass excise taxes and other costs through to consumers.

For a number of years, major U.S. cigarette manufacturers have been faced with lawsuits by private plaintiffs and governmental entities. In response to the growing number of lawsuits, the major cigarette manufacturers settled several claims with the state attorneys general. On November 23, 1998, the major U.S. cigarette manufacturers entered into the MSA with attorneys general representing 46 states, the District of Columbia, Puerto Rico, Guam, the Virgin Islands, American Samoa and the Northern Mariana Islands (the Settling States ) to settle the asserted and unasserted health care cost recovery and certain other claims of those states and territories. Separately, the major cigarette manufacturers settled similar claims on an individual basis that were brought by Florida, Texas, Minnesota and Mississippi (the Non-MSA States ).

Under the MSA and the settlement agreements with the Non-MSA States, the manufacturers that participated in the settlement are obligated to make annual payments to the states. In addition, pursuant to the terms of the MSA, industry participants agreed to various restrictions and limitations regarding the advertising, promotion and marketing of tobacco products in the United States. For a more detailed description of the business restrictions and annual payments due under the MSA, see State Attorney General Settlement Agreements.

The original major manufacturers that negotiated and initially signed the MSA are called the Original Participating Manufacturers ( OPMs ). Some smaller manufacturers who subsequently elected to participate in the MSA are called Subsequent Participating Manufacturers ( SPMs ). OPMs and SPMs are required to make annual MSA payments to the 46 signatory states based on their national sales volumes, regardless of the state in which cigarettes are sold. Manufacturers who elected to comply with the MSA through escrow deposits are referred to as Non-Participating Manufacturers ( NPMs ). NPMs are required to make annual or quarterly escrow deposits to each of the 46 states separately based upon units sold to a particular state and are not required to deposit escrow amounts related to sales in the Non-MSA states. For a more detailed description of signatory payment requirements of OPMs and SPMs and the escrow deposit requirements of NPMs, see State Attorney General Settlement Agreements.

There are four primary categories of manufactured cigarettes in the United States, commonly referred to as Tiers, that are generally determined based upon average price per carton and the level of marketing and promotional support provided at retail: Premium (Tier 1); Branded Savings (Tier 2); Generic (Tier 3); and Deep-Discount (Tier 4).

In general, premium brands contain higher-quality raw materials and packaging and are sold at a higher price point than the generally less established brands in the other tiers. Most of the premium brands are sold by three major cigarette manufacturers, which include Philip Morris USA, Inc., Reynolds America and Lorillard Tobacco Company. These brands historically had considerable funds spent in their support through marketing and advertising, as well as through discounts, coupons and buy-downs. In September 2003, the Company launched its ***ZIG-ZAG*** Premium Cigarette to compete in the premium segment. The Company believes current brand switching trends among adult consumers highlight the opportunity for additional well-known premium entrants.

The discount categories are defined primarily by price. Tier 2 cigarettes are generally less well-recognized brands, sold nationally by major cigarette manufacturers, marketed at lower retail prices. Tier 3 cigarettes are sold at even lower retail prices, have less distribution, in general, than Tier 2 brands and are generally manufactured by SPMs. Tier 4 cigarettes are sold by smaller companies, many of whom are NPMs, and are sold at the lowest retail prices. Manufacturers of Tier 4 cigarettes are fragmented geographically.

The premium category continues to make up the largest share of overall U.S. cigarette sales volumes, with a 73.5% market share in 2005. Of that amount, over 95% are related to sales of the top three major cigarette manufacturers. The discount category (Tiers 2 4) had an approximate 26.5% market share.

Overall industry volumes have decreased at a compound annual rate of 2.3% from 1995 (480 billion units estimated) to 2006 (373 billion units estimated). Competition is primarily based on brand recognition, consumer loyalty, distribution, retail display and promotion, quality and price. Meaningful market share shifts among the major manufacturers require significant discounting and other marketing expenses, however, the MSA contains provisions limiting the ability of OPMs and SPMs to market and advertise cigarettes.

In response to increased competition, large manufacturers have increased promotions and discounts in order to maintain, or at least slow their decline in market share, particularly in the premium category. Further, these premium manufacturers have realigned their strategy by focusing marketing expenditures on their core premium brands. Despite the decline in overall cigarette volumes and the shift toward discount brands, the Company believes that the size of the premium cigarette market still offers meaningful opportunities for a new premium cigarette product with a well-recognized brand name due to consumer behavior and attitudes toward brand switching.

**Products**

Currently, the Company manufactures, markets and distributes loose leaf chewing tobacco for the smokeless tobacco market and packages, markets and distributes MYO smoking tobaccos and related products for the MYO cigarette market, which also includes the marketing and distribution of cigarette papers and related products. The Company is also a manufacturer, marketer and distributor of premium manufactured cigarettes.

**Table of Contents**

*Loose Leaf Chewing Tobacco*

Loose leaf chewing tobacco is made from aged, air-cured tobacco, which is processed and flavored and then packaged in foil pouches. Loose leaf tobacco products can be broadly characterized as either full flavored or mild. The Company sells its loose leaf chewing tobacco products under brand names that include ***Beech-Nut, Trophy, Havana Blossom, Stoker s, Tennessee Chew*** and ***Durango***. The ***Beech-Nut*** brand is available in two flavors, Regular and Wintergreen. ***Beech-Nut*** is a full flavored product. ***Beech-Nut Wintergreen*** was introduced in 1979 and has the largest market share of any premium favored loose leaf brand. The Company introduced the ***Trophy*** brand into the mild product category in 1992. The Company s ***Havana Blossom*** brand is a regional brand, sold primarily is West Virginia, Pennsylvania and Ohio. The ***Stoker s*** and ***Tennessee Chew*** brands were acquired in 2003 and have strength in the southeast of the U.S. The ***Durango*** brand was introduced in March 1998 and is a nationally distributed value brand.

*MYO Products*

The Company s MYO products include ***ZIG-ZAG*** premium cigarette papers, MYO tobacco and related products, such as cigarette tubes, cigarette rolling and injector machines and MYO starter kits.

The Company sells its premium cigarette papers under the ***ZIG-ZAG*** brand. Although premium cigarette papers are sold in a variety of different widths and styles, the Company s primary styles are its standard width ***ZIG-ZAG*** White and ***ZIG-ZAG*** 1/4 sized French Orange premium cigarette papers. Other premium paper products sold under the ***ZIG-ZAG*** name are Kutcorners, which are designed for easier hand-rolling; 1/2 sized; and king-sized.

The Company s MYO tobacco products include its ***ZIG-ZAG*** Classic American Blend and the ***Stoker s No. 2*** and ***Old Hillside*** brands of value-oriented MYO tobaccos, both of which appeal to the price-conscious consumer. ***Stoker s No. 2*** was the first brand of MYO tobacco to be sold in 16 oz. bags, thus contributing to the growth of the value-oriented category.

*Premium Cigarettes*

During September 2003, the Company introduced a new, premium manufactured cigarette under the ***ZIG-ZAG*** brand in the cities of Dallas, Los Angeles, Miami and Seattle. The product has been in these and a number of other test markets since this date and the Company is currently assessing its historic and current test market results and its opportunities in the cigarette market. Prior to March 8, 2006, the Company sourced its cigarettes under a supply agreement with a contract manufacturer; this contract was terminated on March 8, 2006. The Company now purchases tobacco from more than one source. The Company completed the purchase of cigarette manufacturing equipment in 2005, leased a facility in Frankfort, KY and established a cigarette manufacturing facility. The Company began manufacturing cigarettes in 2006 in limited amounts to supply the Company s cigarette test markets.

*Other Products*

In connection with the Stoker acquisition, the Company acquired the Stoker catalog business, which principally sells tobacco and tobacco related products.

**Sales and Marketing**

The Company has a nationwide sales and marketing organization of approximately 115 people. In December 2005, the Company reorganized and realigned its sales and marketing functions to create a unified sales and marketing group, remapped its sales territories to improve the selling effort and focus upon priority markets and sales channels, and increased supervision and efficiencies. The Company has focused and will continue to focus its sales efforts for both its loose leaf chewing tobacco and MYO products on both wholesale distributors and retail merchants in the independent and chain convenience store, drug store and mass merchandising channels as well as the food store and tobacco outlet channels.

Since the 1997 Acquisition, the Company has expanded and intends to continue to expand the sales of its loose leaf chewing tobacco and MYO products into geographic markets and retail channels that had previously been underdeveloped. The Company has established relationships with approximately 1,000 wholesale customers and its products are sold in approximately 100,000 retail locations through the United States. At the retail level, the Company s loose leaf chewing tobacco products are promoted through volume and price-discount programs and the use of innovative, high visibility point-of-purchase floor and shelf displays, banners and posters. The Company has neither relied upon nor conducted any advertising in the consumer media for its loose leaf chewing tobacco products.

The majority of ***ZIG-ZAG*** premium cigarette papers promotional activity is at the wholesale distributor level and consists of distributor promotions, some trade show activity and trade advertising, although the Company has begun some

7

consumer oriented activities. The MYO smoking tobaccos and related products promotional activity is more focused at the retail level with spending on point-of-sale displays and at the consumer level with price-off promotions, primarily through the use of coupons.

The Company occasionally provides to its distributor customers, for redistribution to retailers, point-of-sale materials such as posters, pole signs, display racks and counter top and floor displays. The Company also produces marketing materials for use by distributors and their direct sales force to promote the sale of its products to their retail customers. The Company responsibly focuses its marketing efforts on adult consumers and is committed to full legal compliance in the sale and marketing of its products.

The Company s largest customers, COD Company and the McLane Company, accounted for approximately 11% and 9%, respectively, of its net sales in 2006. The loss of either of these customers could have a material adverse effect on the results of operations, financial position and cash flows of the Company. The Company does not believe that the loss of any other customer would have a material effect on the results of operations, financial position or cash flows of the Company either in the intermediate or long term.

**Distribution Agreements**

NAOC is party to two long-term distribution and licensing agreements with Bolloré with respect to sales of premium cigarette papers, cigarette tubes and cigarette injector machines (collectively, the Products ) in the United States and Canada (collectively, the Distribution Agreements ). Under the Distribution Agreements, Bolloré granted NAOC the exclusive right to purchase the Products bearing the ***ZIG-ZAG*** brand name from Bolloré for resale in the United States and Canada. NAOC has the sole right to determine the price and other terms upon which NAOC may resell any products purchased from Bolloré, including the right to determine the distributors of such products within these countries.

The Distribution Agreements establish the purchase pricing mechanism for premium cigarette papers through December 31, 2009, which allows certain adjustments to reflect increases in the U.S. and Canadian Consumer Price Indices and to account for material currency fluctuations. The Distribution Agreements provide that, in order to assure each of the parties commercially reasonable profits in light of inflationary trends and currency translation factors, prior to December 31, 2004 and each fifth-year anniversary from such date thereafter, the parties would enter into good faith negotiations to agree on an index and currency adjustment formula to replace the index and formula currently in effect. If the parties are unable to agree, the dispute is to be submitted to binding arbitration. The Company and Bolloré have agreed on January 1, 2005 to extend the existing pricing mechanisms for a new five year term.

Pursuant to the Distribution Agreements, export duties, insurance and shipping costs are the responsibility of Bolloré and import duties and excise taxes are the responsibility of NAOC. Bolloré s terms of sale are 45 days from the bill of lading date and its invoices are payable in Euros. The Distribution Agreements reduce catastrophic foreign exchange risk by providing that Bolloré will bear certain exchange rate risks at levels fixed through 2004, which terms have been extended through 2009.

According to the Distribution Agreements, NAOC must purchase the Products from Bolloré, subject to Bolloré fulfilling its obligations under these agreements. Bolloré is required by the agreements to provide NAOC with the quantities and quality of the products that it desires. The Distribution Agreements provide NAOC with certain safeguards to help ensure that NAOC will be able to secure a steady supply of product. Such safeguards include (i) granting NAOC the right to seek third party suppliers with continued use of the ***ZIG-ZAG*** trademark if Bolloré is unable to perform its obligations or ceases its cigarette paper manufacturing operation, in each case as set forth in the Distribution Agreements, and (ii) maintaining a two month supply of safety stock inventory of the premium papers, tubes and injector machines in the United States at Bolloré s expense.

Under the Distribution Agreements, NAOC has also agreed for a period of five years after the termination of such Distribution Agreements not to engage, directly or indirectly, in the manufacturing, selling, distributing, marketing or otherwise promoting in the United States and Canada, of premium cigarette paper or premium cigarette paper booklets of a competitor without Bolloré s consent, except for certain de minimis acquisitions of debt or equity securities of such a competitor and certain activities with respect to an alternative supplier used by NAOC as permitted under the Distribution Agreements.

Each of the Distribution Agreements was entered into on November 30, 1992. Each of the U.S. Distribution Agreement and the Canada Distribution Agreement was for an initial twenty year term commencing on the date of such agreement and will be renewed automatically for successive twenty year terms unless terminated in accordance with the provisions of such agreement. Each of the Distribution Agreements permits Bolloré to terminate such agreement (i) if certain minimum

purchases (which, in the case of the U.S. Distribution Agreement and the Canada Distribution Agreement have been significantly exceeded in recent years) of premium cigarette paper booklets have not been made by the Company for resale in the jurisdiction covered by such agreement within a calendar year; (ii) if the Company assigns such agreement without the consent of Bolloré (other than certain permissible assignments to wholly owned subsidiaries of the Company); (iii) upon a change of control of NAOC or any parent of NAOC without the consent of Bolloré; (iv) upon certain acquisitions of equity securities of NAOC or any parent of NAOC by a competitor of NAOC or certain investments by significant stockholders of the Company in a competitor of NAOC; and (v) certain material breaches, including NAOC s agreement not to promote, directly or indirectly, premium cigarette paper or premium cigarette paper booklets of a competitor. Additionally, the Canada Distribution Agreement is terminable by either NAOC or Bolloré upon the termination of the U.S. Distribution Agreement.

**Patents, Trademarks and Trade Secrets**

The Company has numerous registered trademarks relating to its loose leaf chewing tobacco and MYO tobacco products, including the trademarks for its ***Beech-Nut***, ***Trophy, Havana Blossom***, ***Durango, Stoker s, Stoker s Classic, Stoker s 117, Stoker s No. 1, and Smoker s Number 2, Tequila Sunrise, Fred s Choice***, ***Old Hillside***, ***Our Pride*** and ***Tennessee Chew*** products. The Company is applying for registration of its ***Black Mountain, Comfort Cut, Moonshine Blend, and Sweet & Smokey*** trademarks. The registered trademarks, which are significant to the Company s business, expire periodically and are renewable for additional 10-year terms upon expiration. Flavor and blend formulae trade secrets relating to NTC s and NAOC s tobacco products, which are key assets of their businesses, are maintained under strict secrecy. The ***ZIG-ZAG*** trade name and trademark for premium cigarette papers and related products are owned by Bolloré and have been exclusively licensed to NAOC in the United States and Canada. NAOC owns the ***ZIG-ZAG*** trademark with respect to tobacco products. The Company s catalog business is operated under the Fred Stoker & Sons, Inc. name.

**Raw Materials, Product Supply and Inventory Management**

*Loose Leaf Chewing Tobacco*

NTC s loose leaf chewing tobacco is produced from air-cured and fire-cured leaf tobacco. NTC utilizes tobaccos grown domestically in Pennsylvania, Wisconsin, Tennessee and Kentucky as well as those imported from countries such as Argentina, Brazil, France, Germany, Indonesia, Italy, and the Philippines. Management does not believe that it is dependent on any single country or supplier source for tobacco. Pursuant to agreements with NTC, Lancaster Leaf Tobacco Company of Pennsylvania, a wholly owned subsidiary of Universal Leaf Corporation ( Lancaster ) and Hail & Cotton Inc. of Tennessee, a wholly owned subsidiary of Luckett Tobaccos, Inc. ( H&C ), (i) purchases and processes tobacco, (ii) stores tobacco inventory purchased on behalf of NTC and (iii) generally maintains a 12- to 24-month supply of NTC s various tobacco types at their facilities. NTC generally maintains up to a two-month operating supply of tobacco at its manufacturing facilities in Louisville, Kentucky.

In addition to raw tobacco, NTC s loose leaf chewing tobacco products include food grade flavorings, all of which have been approved by the Food and Drug Administration and/or other federal agencies. NTC is not dependent upon any single supplier for those raw materials or for the supply of its packaging materials.

NTC generally maintains up to a two-month supply of finished loose leaf chewing tobacco. This supply is maintained at the Louisville facility and in four regional bonded public warehouses to facilitate distribution.

*MYO Products*

Pursuant to NAOC s Distribution Agreements with Bolloré, NAOC must purchase its premium cigarette papers, cigarette tubes and cigarette injecting machines from Bolloré, subject to Bolloré fulfilling its obligations under these agreements. If Bolloré is unable or unwilling to perform its obligations or ceases its cigarette paper manufacturing operation, in each case as set forth in the Distribution Agreements, NAOC may seek third-party suppliers and continue the use of the ***ZIG-ZAG*** trademark. To ensure that NAOC has a steady supply of premium cigarette paper products as well as each style of cigarette tubes and injectors, Bolloré is required to maintain, at its expense, a two-month supply of inventory in a public warehouse in the United States. See Distribution Agreements.

To facilitate general distribution, in addition to the inventory maintained by Bolloré, NAOC also maintains a supply of its products at the Louisville facility and in four regional bonded public warehouses.

NAOC obtains their MYO smoking tobaccos primarily from international sources and are not dependent on any one type of tobacco for its blends. NAOC purchases these smoking tobaccos principally through multiple purchasing agents. The MYO related products are purchased in finished form from various suppliers at Bolloré s direction.

Bolloré has from time to time been unable to produce and supply the Company with sufficient quantities of cigarette tubes and injectors. Bolloré has not, however, experienced any problems supplying the Company with sufficient quantities of its premium cigarette paper products.

*Premium Cigarettes*

The Company purchases all of the raw materials used in the manufacture of its ***ZIG-ZAG*** Premium Cigarettes, including the tobacco, papers, filters and packaging, and arranges for the raw materials to be delivered to its manufacturing operation in Frankfort, Kentucky. Similar to the Company s arrangement with Lancaster Leaf Tobacco Company of Pennsylvania for its loose leaf chewing tobacco products, Blending Services International, Inc., a wholly-owned subsidiary of Universal Leaf Corporation, has been the purchaser of the tobacco used in its ***ZIG-ZAG*** Premium Cigarettes. Kentucky Cut Rag, LLC of Kentucky stores leaf and processes the tobacco, and the Company stores the processed tobacco in its Frankfort, Kentucky facility. The Company generally maintains a one-year supply of leaf tobacco at Kentucky Cut Rag, LLC. The Company obtains the other raw materials for its ***ZIG-ZAG*** Premium Cigarettes from various other sources. The Company is not dependent on one single source for any of its raw materials.

Prior to March 8, 2006, the Company sourced its cigarettes under a supply agreement with a contract manufacturer; this contract was terminated on March 8, 2006. The Company now purchases tobacco from more than one source. The Company completed the purchase of cigarette manufacturing equipment in 2005, leased a facility in Frankfort, KY and established a cigarette manufacturing facility. The Company began manufacturing cigarettes in 2006 in limited amounts to supply the Company s cigarette test markets. The Company is currently assessing its cigarette operation.

**Manufacturing**

The Company s NTC subsidiary manufactures its loose leaf chewing tobacco products at its manufacturing facility in Louisville, Kentucky. They also contract for the manufacture of their premium cigarette papers, cigarette tubes, rolling and injector machines and MYO smoking tobaccos. In the case of its MYO smoking tobacco products, the subsidiaries complete the processing of and packaging of these products at their manufacturing facility in Louisville. The Company consolidated its manufacturing operations into its Louisville manufacturing facility in 2004, eliminating one of its two leased manufacturing facilities in Dresden Tennessee. The Company believes that its production capabilities, quality control procedures, research and development activities and overall facilities and equipment are adequate for its projected operations. NTC also manufactures cigarettes at its leased facility in Frankfort, Kentucky.

*Production and Quality Control*

The Company uses proprietary production processes and techniques, including strict quality controls. NTC s quality control group periodically tests the quality of the tobacco; flavorings; application of flavorings; premium cigarette papers, tubes and injectors; and packaging materials. The Company utilizes sophisticated quality control and pilot plant production equipment to test and closely monitor the quality of its products. The quality of the Company s products is largely the result of using high grade tobacco leaf, food-grade flavorings and an ongoing analysis of tobacco cut, flavorings and moisture content.

Given the importance of contract manufacturing to the Company, the Company s quality control group ensures that established written procedures and standards are adhered to by each of its contract manufacturers.

*Research and Development*

The Company has a Research and Development Department that reformulates existing loose leaf and MYO tobacco products in an effort to maintain a high level of product consistency and to facilitate the use of less costly raw materials without sacrificing product quality. The Company believes that for all of its tobacco products, including MYO, it has been and will continue to be able to develop cost effective blends of tobacco and flavorings that will maintain or reduce overall costs without compromising high product quality. The Research and Development Department is also responsible for new product development, which includes the development and testing of ***ZIG-ZAG*** Premium Cigarettes.

The Company spent approximately $563,000, $664,000, and $521,000 on its research and development and quality control efforts for the years 2006, 2005 and 2004, respectively.

*Facilities*

NTC s Louisville facility was formerly owned and used by Lorillard for the manufacture of cigarettes, little cigars and chewing tobacco. This approximately 600,000 square foot facility occupies a 26-acre urban site near downtown Louisville.

The facility s structures occupy approximately one-half of the total acreage. The facilities are in good condition and have received regular maintenance and capital improvements. NTC also manufactures cigarettes at its leased facility in Frankfort, Kentucky. NTC leases a facility in Dresden Tennessee which services the Fred Stoker & Sons, Inc. catalog business, handles product returns and produces small amounts of test and other products.

The Company believes its production capabilities, quality control procedures, research and development and overall facilities and equipment are adequate for its projected operations.

**Competition**

The Company, through NTC and Stoker, is the third largest manufacturer and marketer of loose leaf chewing tobacco in the United States. The other three principal competitors in the loose leaf chewing tobacco segment, which, together with the Company, generate approximately 98% of this segment s sales, are Swedish Match North America, Inc., the Conwood unit of Reynolds America and Swisher International Group Inc. Management believes that moist snuff products are used interchangeably with loose leaf products by many consumers and, as a result, US Smokeless Tobacco Company, the largest manufacturer of moist snuff (and of all smokeless tobacco products when taken as a whole) is also a significant competitor. As indicated above under Industry and Markets, sales of discount moist snuff have grown over the past decade while sales of loose leaf have declined during that same period. In addition, the Company s three principal competitors in the loose leaf chewing tobacco segment also manufacture and market moist snuff.

NAOC is the largest importer and distributor in North America of premium cigarette papers. NAOC s three major competitors for premium cigarette paper sales are Republic Tobacco, L.P., Robert Burton Associates, Inc., a wholly-owned subsidiary of Imperial Tobacco Group plc and VCT B.V. Although there is no source for comprehensive industry data, the Company believes that it, together with these three companies, collectively, have a market share in excess of 98% of the premium cigarette papers market.

The Company s principal competitors in the MYO segment are Republic Tobacco, L.P., in conjunction with its TOP Tobacco, L.P. subsidiary, and Lane Ltd, a unit of Reynolds America, Inc., the second largest cigarette company in the United States. Many other companies also compete in this segment, including Peter Stokkebye International A/S, which has licensed its distribution to Commonwealth Brands, and Santa Fe Natural Tobacco, a unit of Reynolds America Inc. These competitors, unlike the Company, all are granted protected share under the cigarette MSA which allows them to avoid a substantial amount of their payment obligations under that agreement and avoid making additional equity assessment payments in Michigan, Utah and Alaska. The Company does not have protected share and therefore is at an economic disadvantage with respect to those competitors. (See State Attorney General Settlement Agreements. )

The Company s primary competitors in the manufactured cigarette market are the three majors : Philip Morris USA, Inc., the brands of which accounted for approximately 50% of all cigarette sales in the United States in 2006; R.J. Reynolds Tobacco Company Inc., the brands of which accounted for 30%; and Lorillard Tobacco Company, the brands of which account for approximately 10%, as well as Commonwealth Brands and Vector Group Ltd. (the parent company of Liggett Group Inc.), the brands of which collectively account for approximately 4.5%.

Many of the Company s competitors are better capitalized than the Company and have greater financial and other resources than those available to the Company. The Company believes that its ability to effectively compete and its strong market positions in its principal product lines are due to its high brand recognition and the perceived quality of each of its products, its manufacturing and operating efficiencies, and its sales, marketing and distribution efforts.

**Employees**

As of March 16, 2007, the Company employed a total of 299 full-time employees. With the exception of 104 manufacturing employees, none of the Company s employees are represented by unions. The unionized employees are covered by three collective bargaining agreements. Two of these agreements, covering 102 employees, will expire in January 2008. The other agreement, covering two employees, will expire in April 2008.

**Regulation**

The tobacco industry and, in particular, cigarette manufacturers have been under public scrutiny for over forty years. Industry critics include special interest groups, the U.S. Surgeon General and many legislators and regulators at the state and federal levels. Although smokeless tobacco companies have recently come under some scrutiny, the principal focus has been directed at the manufactured cigarette market due to its large size relative to the smokeless tobacco market and the MYO segment of the cigarette market. However, the regulatory environment could be effected by the continued growth of the moist snuff segment of the smokeless tobacco market as well as the entry into the moist snuff segment

by major cigarette manufacturers.

Producers of tobacco products are subject to regulation in the United States at the federal, state and local levels. Together with changing public attitudes towards tobacco consumption, the constant expansion of regulations, including increases in various taxes, requirements that tobacco products be displayed behind-the-counter and public smoking restrictions, has been a major cause of the overall decline in the consumption of tobacco products since the early 1970 s. Moreover, the future trend is toward increasing regulation of the tobacco industry at all jurisdictional levels.

In 1996, the U.S. Food and Drug Administration (the FDA ) promulgated regulations asserting jurisdiction over tobacco products. These regulations, among other things, included severe restrictions on the manufacture, distribution and sale of tobacco products and required compliance with a wide range of advertising and promotion, labeling, reporting, record keeping, manufacturing and other requirements, among other things. On March 21, 2000, the U.S. Supreme Court ruled that the FDA does not have the authority to regulate tobacco products without more explicit direction from Congress and that the FDA regulations were unconstitutional. The Company remains, however, subject to regulation by numerous other federal agencies, including the Federal Trade Commission ( FTC ), the Alcohol and Tobacco Tax and Trade Bureau ( TTB ), the Federal Communications Commission ( FCC ) and the United State Department of Agriculture ( USDA ). If Congress were to enact legislation granting the FDA specific authority over tobacco products, the FDA s exercise of jurisdiction could lead to more expansive FDA-imposed restrictions on tobacco operations than those set forth in the existing regulations.

In 2004, Congress passed a federal buyout program for tobacco farmers. The costs associated with the quota buy-out are borne by all importers and domestic manufacturers selling any form of tobacco product sold in the U.S. The buy-out provides for a $10 billion payment to farmers over a 10 year period, with payments based on a calculation of assessed market share in each tobacco product segment. Payments under the buyout scheme are assessed quarterly on manufacturers beginning March 31, 2005 and ending March 31, 2015. The buyout assessment rates per unit for the Company s primary business categories through March 2006 were projected within the following range by the U.S. Department of Agriculture: Loose Leaf, $0.0249 $0.0288 per pound; MYO, $0.1054 $0.1324 per pound; Cigarettes, $0.0023 $0.0028 per cigarette.

In recent years, a variety of bills relating to tobacco issues have been introduced in the U.S. Congress, including bills that would (i) prohibit the advertising and promotion of all tobacco products and/or restrict or eliminate the tax deductibility of such advertising expenses; (ii) increase labeling requirements on tobacco products to include, among other things, additional warnings and lists of additives and toxins; (iii) modify federal preemption of state laws to allow state courts to hold tobacco manufacturers liable under common law or state statutes; (iv) shift regulatory control of tobacco products and advertisements from the Federal Trade Commission to the Food and Drug Administration; (v) increase tobacco excise taxes; (vi) regulate the burning propensity of cigarettes; and (vii) require tobacco companies to pay for health care costs incurred by the federal government in connection with tobacco related diseases. Hearings have been held on certain of these proposals; however, to date, none of such proposals have been enacted by Congress. Future enactment of such proposals or similar bills, depending upon their content, could have a material adverse effect on the results of operations or financial condition of the Company.

While there are no current federal regulations that materially and adversely affect the sale of premium cigarette papers, a number of states have in recent years enacted state excise taxes on cigarette papers, these include Kentucky, Indiana, Arkansas and Rhode Island. There can be no assurance that federal, state or local regulations will not be enacted which will seek to regulate or ban the sale of premium cigarette papers. In the event such regulations are enacted, depending upon their parameters, they could have a material adverse effect on the results of operations, financial position and cash flows of NAOC and the Company.

The Company s catalog business is also subject to various federal, state and local regulations, which, among other things, prohibit the sale of tobacco products to minors. Further regulations could have an adverse impact on the Company s catalog business.

**State Attorney General Settlement Agreements**

On November 23, 1998, the major U.S. cigarette manufacturers, Philip Morris USA, Inc., Brown & Williamson Tobacco Corporation, Lorillard Tobacco Company and R.J. Reynolds Tobacco Company, entered into the MSA with attorneys general representing the Settling States. The MSA settled all the asserted and unasserted health-care cost recovery actions brought by, or on behalf of, the settling jurisdictions.

In the Settling States, the MSA released all signing parties from all claims of the Settling States and their respective political subdivisions and other recipients of state health-care funds (i) relating to past conduct arising out of the use, sale, distribution, manufacture, development, advertising, marketing or health effects of, the exposure to, or research, statements or warnings about, tobacco products and (ii) relating to future conduct arising out of the use of, or exposure to, tobacco products that have been manufactured in the ordinary course of business.

The MSA also contains provisions restricting signatory companies in their advertising, promotion and marketing of cigarettes in the U.S. Among these are restrictions or prohibitions on the use of cartoon characters, brand name sponsorships, targeting of youth, outdoor advertising, event sponsorship (such as concerts and sporting events), payments for product placement, providing free samples, and branded apparel and merchandise.

*Required Payments*

The MSA required the four OPMs to make a series of initial payments over five years totaling $13.2 billion. The last of these five payments was paid on January 10, 2003. The MSA also requires annual industry payments for participating manufacturers which were $8.0 billion in 2004, but will increase to $8.13 billion in 2008, and to $9.0 billion in 2017 and thereafter in perpetuity. Ten additional strategic contribution payments of $861 million are due annually beginning in April 2008. All payments are to be allocated among the OPMs on the basis of relative national market share and most are subject to adjustments, including but not limited to, adjustments for inflation, volume, loss of market share to SPM s and NPM s, operating income, and payments to the four Non-MSA States.

*National Public Education Fund*

In addition, the MSA calls for the creation of a national foundation that would establish public education and other programs, and conduct or sponsor research, to reduce youth smoking, and to understand and educate the public about diseases associated with tobacco product use. OPMs agreed to fund the foundation with (i) ten annual payments of $25 million due by March 31 of each year until 2008 and (ii) five additional payments totaling $1.45 billion due by March 31 of each year that increased from $250 million in the first year to $300 million in each of the subsequent four years. The last of these five payments was paid on March 31, 2003. In addition, if for any calendar year beginning with 2003, the OPMs have an aggregate market share of 99%, the OPMs are obligated to pay $300 million to the Fund by April 15th of the following year. In 2005, the OPM s had an estimated 84% of the market. Each of these payments is to be allocated among the OPMs on the basis of relative market share. Other than the $25 million annual payments and the $250 million payment made on March 31, 1999, the payments for the foundation are subject to adjustments for changes in sales volume units, inflation and other factors.

*MSA Fees and Litigation Costs*

The OPMs also agreed to pay the litigation costs, including government attorneys fees, of the offices of the Attorneys General relating to the settled cases and, subject to certain quarterly and annual payment caps, the costs and fees of outside counsel to the jurisdictions.

*Inflation Adjustment*

The inflation adjustment applied to annual and strategic contribution payments and to payments for the benefit of the national public education fund established by the foundation. It increases payments on a compound annual basis by the greater of 3% or the actual total percentage change in the consumer price index for the preceding year. The inflation adjustment is measured starting with inflation for 1999.

*Volume Adjustment*

The volume adjustment applies to initial payments, annual and strategic contribution payments and payments for the benefit of the national public education fund established by the foundation. It increases or decreases payments for OPMs based on the increase or decrease in the total number of cigarettes shipped in or to the 50 states, the District of Columbia and Puerto Rico by the OPMs during the preceding year, as compared to the 1997 base number of cigarettes shipped by the OPMs. When volume has increased, the volume adjustment increases payments by the same percentage as the number of cigarettes exceeds the 1997 base number. When volume has decreased, the volume adjustment decreases payments by a percentage equal to 98% of the percentage reduction in volume. There are also limits to the extent to which OPMs can benefit by volume decreases in years where OPMs achieve certain increases in aggregate operating income.

*Subsequent Participating Manufacturers*

Under the MSA each SPM is required to make payments in any year that equal, on a per-cigarette basis, the sum of the annual and strategic contribution payments and payments for the benefit of the national public education fund by the OPMs in that year, provided that SPMs who signed the MSA within 90 days of its effective date are required to make such payments only on unit volumes that represent the increase in its market share in such year over the greater of the SPM s 1998 market share or 125% of its 1997 market share.

13

**Table of Contents**

*Non-Participating Manufacturers*

Each of the states which are parties to the MSA, except for a few territories, has enacted a statute as provided for in the MSA to address manufacturers that do not participate in the MSA. The statutes require that any cigarette manufacturer or any MYO tobacco manufacturer that is not a signatory to the MSA make payments into an escrow fund to cover possible future liabilities to the relevant Settling State. The payment required by an NPM under the state statutes is calculated on a per cigarette or a cigarette equivalent basis for MYO. Some smaller manufacturers who were not a party to the state litigation against the OPMs have chosen to remain outside the MSA and operate as escrow compliant NPMs.

The Company was not a party to the state litigation against the OPMs. The Company has chosen to participate as an escrow compliant NPM. As of December 31, 2006, the Company had deposited approximately $21.5 million into an escrow fund to maintain state-by-state compliance.

Under the escrow statutes, NPMs pay the lesser of the rates stated in the statutes or the amount that the NPM would have paid had it been a hypothetical SPM under the MSA. Recent legislation adopted in some 44 states has eliminated the share provision of the escrow state that allowed an NPM to recover any overpayment it may have made under the NPM allocable share formula. Since the payment calculations (to a state as an SPM or to an escrow account as an NPM) had been different, the payment to escrow could have been smaller on a unit basis than the payment to the MSA would be, depending on the state in which the NPM marketed its cigarettes. As a result of this change in the legislation, an NPM must now escrow an amount almost equivalent to the amount a similarly situated SPM must pay under the MSA payment formula.

The NPM escrow deposits are required to be held for 25 years and remain the property of such NPM. During the holding period, the NPMs have the right to receive the earnings on such deposits. On the 25th anniversary of each annual deposit, the principal amount of escrow remaining for that year will be returned to the NPM.

As a condition of maintaining annual OPM and SPM payments, the state Attorneys General have an obligation to diligently enforce the state obligations provisions of the MSA and the State Statute, and have been taking increased action to ensure compliance by all NPMs. As a result, the Company expects that there may be further consolidation among smaller Tier 4 cigarette manufacturers, who lack efficient manufacturing operations, wide distribution, or the resources to meet the higher state escrow obligation required by the allocable share amendment change to the escrow statute.

In 2004, Michigan, Utah and Alaska passed new legislation that places additional payment obligations on NPM products sold in these states. In addition to making escrow payments, NPM s must now make an additional advance payment on cigarette and MYO sales based on anticipated cigarette or MYO sales in the state. These equity assessment payments range from $3.50 to $5.00 per carton on manufactured cigarettes, and $1.22 to $1.50 per pound of MYO tobacco. Such equity assessments limit the ability of NPM s to compete against OPM s and SPM s that are not required to make these additional payments in these states. The Company currently sells MYO products in the above states.

*Growers Trust*

As part of the MSA, the OPMs agreed to work with U.S. tobacco growers to address the possible adverse economic impact of the MSA on growers. As a result, the OPMs agreed to participate in funding a $5.2 billion trust fund to be administered by a trustee, in conjunction with a certification entity from each of the tobacco growing communities in 14 states. The trust agreement was dissolved in 2004 as a result of the adoption by Congress of the federal tobacco quota buyout program. The trust agreement had provided for a schedule of aggregate annual payments, subject to various adjustments, that were payable in quarterly installments each year from 1999 through 2010.

*Payment Obligations in Non-MSA States*

In June 1994, the Mississippi attorney general brought an action, *Moore v. American Tobacco Co*., against various US tobacco companies. This case was brought on behalf of the state to recover state funds paid for health care and medical and other assistance to state citizens suffering from diseases and conditions allegedly related to tobacco use. The large cigarette manufacturer defendants settled the Mississippi case in 1998, and also, at later dates, similar cases in Texas, Florida and Minnesota. Future payments under the settlement agreements with these Non-MSA States will be allocated among the OPMs on the basis of relative unit volume of domestic cigarette shipments, and will be subject to adjustment for inflation and for changes in the volume of domestic cigarette shipments on terms substantially similar to those in the MSA states. There are no requirements imposed on NPMs in the Non-MSA States as a result of these settlements. The MSA required the OPMs to make a series of initial payments to the Non-MSA States over five years totaling $6.9 billion, the last of which was paid in 2003. On December 31, 2001, and on each December 31 thereafter, the OPMs were required to pay 17% of $6.5 billion in 2001 and 2002 and will be required to pay 17% of $8.0 billion in 2003 and thereafter to the Non-MSA States.

14

In 2003, the State of Minnesota enacted a new statute requiring non-signatory companies to the Minnesota tobacco settlement to pay a fee in-lieu of settlement or equity assessment on all cigarette products sold in the State. The statute does not extend to MYO products. The Company does not currently sell manufactured cigarette products in the state of Minnesota. The Council of Independent Tobacco Manufacturers of America (CITMA) filed suit challenging the fee. The CITMA case was denied on appeal and a Writ of Certiorari to the US Supreme Court was rejected. In 2006, the states of Texas, Florida and Mississippi all considered but rejected similar equity assessments on non-signatory companies.

*Recent Developments*

The MSA has and is currently being challenged as unconstitutional in several federal court legal actions. The grounds asserted have varied from case-to-case but have included challenges based on the Commerce Clause, the Interstate Compact Clause, the Due Process and Equal Protection Clauses and the Preemption Doctrine. The preemption argument has asserted that the MSA and the associated state escrow legislation constitutes an illegal output cartel under Section 1 of the Sherman Act, and are, therefore, preempted by virtue of the Supremacy Clause of the U.S. Constitution. The Supremacy Clause provides that federal law, in this case the Sherman Act, takes priority over inconsistent state laws, here the escrow statutes.

Until recently, courts have rejected those claims. In two cases arising in the United States Court of Appeals for the Third Circuit, *A.D. Bedell Wholesale Co. v. Philip Morris Inc.*, 263 F.3d 239 (3d Cir. 2001) and *Mariana v. Fisher,* 338 F.3d 189 (3d Cir. 2003), the Court held that the MSA constituted an output cartel that would ordinarily be illegal per se under the Sherman Act, but that it was protected under the Noerr-Pennington doctrine, and therefore immune from liability. The Noerr-Pennington doctrine generally provides that the act of petitioning the government (e.g., legislative lobbying or litigating) is protected under the First Amendment and immune from liability.

On January 6, 2004, the United States Court of Appeals for the Second Circuit issued an opinion in which it concluded, under the allegations in that case, that the MSA and associated escrow legislation could be construed as an output cartel and that it would not be protected under the Noerr-Pennington doctrine. The case was remanded to the district court for further proceedings. *Freedom Holdings Inc. v. Spitzer*, 357 F.3d 205, rehearing denied, 363 F.3d 149 (2d Cir. 2004). The District Court held hearings and issued a ruling, holding on a motion for a preliminary injunction that the MSA was not an illegal cartel, but that certain New York legislation extending the reach of the MSA was illegal under the antitrust laws. Identical statutes have been passed in many of the MSA states. New York State elected not to appeal that ruling. On appeal, the Second Circuit affirmed the District Court s denial of a preliminary injunction but remanded the case for further proceedings.

If the Second Circuit s analysis prevails over the Third Circuit s, and the facts as alleged in the Freedom Holdings are proven, those provisions of the MSA that give rise to the output cartel would be declared illegal. Due to other provisions of the MSA, the major manufacturers would be required to enter into a new settlement with the states. Management believes, although no assurance can be given, the Company and its subsidiaries would benefit since (i) it would have maintained its favorable business development options, (ii) it would likely receive a refund of its escrow funds, and (iii) it would not likely have to escrow funds going forward. However, should the Third Circuit s analysis prevail over the Second Circuit, the Company will not be adversely affected since the Third Circuit s analysis merely maintains the status quo.

Similarly, in *Grand River Enterprises, Six Nations, Ltd. vs. Pryor, 425 F.3d 158 (2d Cir.2005),* involving constitutional, antitrust and statutory challenges to the escrow statute and complementary legislation, the trial court dismissed all claims but the antitrust claim and dismissed non-New York defendants for lack of personal jurisdiction. The Second Circuit affirmed in part and reversed in part. The court reversed on personal jurisdiction, finding that personal jurisdiction could be obtained over all of the MSA settling states in New York based on the execution of the agreement in New York. The court affirmed the dismissal of the plaintiffs Indian Commerce Clause, due process and equal protection claims, but reversed the dismissal of the plaintiffs dormant commerce clause claim. Thus, the court found that the plaintiffs complaint had stated valid commerce clause and antitrust claims in challenging the escrow statute and MSA. The State Attorneys General filed a Writ of Certiorari to the US Supreme Court seeking review of the jurisdictional issues raised, but this petition has been denied. In March 2007, the Second Circuit denied Grand River s Preliminary Injunction request regarding the implementation of Allocable Share Amendment in the MSA signatory states.

Additionally, Xcaliber International, a non-participating manufacturer based in Oklahoma, has filed an antitrust claim in the US District Court Eastern District of Louisiana, Fifth Circuit (*Xcaliber International LLC vs Charles C Foti., Jr. et al*). The case asserts a Sherman Act Preemption claim, such as in the Freedom Holdings case, and First and Fourteenth Amendment constitutional claims. All claims had been dismissed by the district court, from which an appeal was taken. The 5th Circuit reversed the district court ruling and reinstated the claims. The case is presently in discovery, with a pending Motion to Compel against the State of Louisiana which challenges various assertions of attorney-client privilege over a wide range of documents. The case is expected to proceed to trial in 2007.

Table of Contents

The Competitive Enterprise Institute ( CEI ), a private organization that supports free business enterprise principals, has also filed suit in the US District Court Western District of Louisiana (*A B Coker et al vs. Charles C. Foti. Jr., et al),* alleging that the MSA is unconstitutional because it violates the Compact Clause of the US Constitution: *No State shall, without the Consent of Congress enter into any Agreement or Compact with another State (Article I, Section 10).* CEI argues that the Compact Clause was meant to prevent states from collectively encroaching on federal power or ganging up on other states. CEI claims the MSA has set up a national government/tobacco cartel that harmed consumers and small businesses by increasing cigarette prices and restricting competition. The state filed a motion to dismiss, which has been denied. CEI have indicated publicly that following discovery they will move for summary judgment. If successful, the CEI case could fundamentally challenge the legal basis upon which the MSA has been able to operate to date.

In an international challenge to the provisions of the MSA, Grand River Enterprises ( GRE ), a Canadian company, challenged the escrow payments and allocable share amendment provisions of the state escrow statutes. GRE is utilizing Chapter 11 of North American Free Trade Agreement ( NAFTA ) as the basis for its claims, and seeks $340 million in compensation for the manner which the MSA has purportedly infringed the company s NAFTA-established rights. *(Grand River Enterprises et al, vs. United States: In the Arbitration under Chapter 11 of NAFTA and the UNCITRAL Arbitration Rules*). In a July 2006 ruling the NAFTA/UNCITRAL Dispute Resolution Tribunal denied the GRE petition relating to the escrow payments system, but allowed GRE to file an amended claim specifically on the issue of the state allocable share amendments to the escrow statutes. The amended complaint was filed in November 2006 and remains subject to review by the Tribunal.

**Excise Taxes**

Tobacco products and premium cigarette papers have long been subject to federal, state and local excise taxes, and such taxes have frequently been increased or proposed to be increased, in some cases significantly, to fund various legislative initiatives. Since 1986, smokeless tobacco (including dry and moist snuff and chewing tobacco) has been subject to federal excise tax. Smokeless tobacco is taxed by weight (in pounds or fractional parts thereof) manufactured or imported. Effective January 1, 2002, the federal excise tax on loose leaf chewing tobacco was increased to $0.195 per pound from $0.17 per pound. Effective January 1, 2002, the federal excise tax on premium cigarette paper was increased to $0.0122 from $0.0106 per fifty papers, the federal excise tax on cigarette tubes was increased to $0.0244 from $0.0213 per fifty tubes, and the federal excise tax on RYO tobacco was increased to $1.0969 from $0.9567 per pound. Any future enactment of increases in federal excise taxes on the Company s products could have a material adverse effect on the results of operations or financial condition of the Company. The Company is unable to predict the likelihood of passage of future increases in federal excise taxes.

Tobacco products and premium cigarette papers are also subject to certain state and local taxes. The imposition of state and local taxes in a jurisdiction could have a detrimental impact on sales in that jurisdiction. Any enactment of new state or local excise taxes or an increase in existing excise taxes on the Company s products is likely to have an adverse effect on sales.

Cigarettes are also subject to substantial and increasing excise taxes. On January 1, 2002, the federal excise tax included in the price of cigarettes increased by $2.50 to $19.50 per thousand cigarettes (or $0.39 per pack of 20 cigarettes). Additional excise taxes, which are levied upon and paid by the distributors, are also in effect in the 50 states, the District of Columbia and many municipalities. Various states have proposed, and certain states have recently passed, increases in their state tobacco excise taxes. The state taxes generally range from $.07 to $2.85 per package of 20 cigarettes. Future enactment of increases in federal excise taxes on the Company s Cigarettes, RYO and smokeless tobacco products could adversely affect demand for them and have a material adverse effect on the Company s results of operations, financial position and cash flows. In addition, further increases in state and local excise taxes could affect demand for the Company s products. The Company is unable to predict the likelihood of passage or magnitude of future increases in excise taxes.

**Environmental Regulations**

The Company believes that it is currently in substantial compliance with all material environmental regulations and pollution control laws.

**Other**

Additional information in response to Item 1 can be found in Note 23 (Segment Information) to the consolidated financial statements.

Table of Contents

**Item 1A. Risk Factors**

**Risks Related to Legal and Regulatory Compliance**

Manufacturers and sellers of tobacco products are subject to regulation at the federal, state and local levels. Such regulations include, among others, labeling requirements, limitations on advertising, and prohibition of sales to minors. The trend in recent years has been toward increased regulation of the tobacco industry. There can be no assurance as to the ultimate content, timing or effect of any regulation of tobacco products by any federal, state or local legislative or regulatory body, nor can there be any assurance that any such legislation or regulation would not have a material adverse effect on our financial position, results of operations or cash flows.

The tobacco industry has experienced and is experiencing significant product liability litigation. Most tobacco liability lawsuits have been brought against manufacturers and sellers of cigarettes for injuries allegedly caused by smoking or by exposure to smoke. However, several lawsuits have been brought against manufacturers and sellers of smokeless tobacco for injuries to health allegedly caused by use of smokeless tobacco. Typically, such claims assert that use of smokeless tobacco is addictive and causes oral cancer. As discussed in Note 21 to the consolidated financial statements included herein, the Company was named as a defendant in such a lawsuit. There can be no assurance that we will not sustain losses in connection with such lawsuits and that such losses will not have a material adverse effect on our financial position, results of operations or cash flows or that additional lawsuits will not be brought against us.

Forty-six states, certain U.S. territories and the District of Columbia are parties to the MSA and the Smokeless Tobacco Master Settlement Agreement ( STMSA ). To our knowledge, the signatories to the MSA include 49 cigarette manufacturers and/or distributors and the only other signatory to the STMSA is US Smokeless Tobacco Company. In our opinion, the fundamental basis for each agreement is the states consents to withdraw all claims for monetary, equitable and injunctive relief against certain tobacco products manufacturers and others and, in return, the signatories have agreed to certain marketing restrictions and regulations as well as separately making certain payment obligations.

Pursuant to the MSA and subsequent states statutes, a cigarette manufacturer (which is defined to also include make-your-own cigarette tobacco) has the option of either becoming a signatory to the MSA or opening, funding and maintaining an escrow account, with sub-accounts on behalf of each settling state. The STMSA has no similar provisions. The MSA escrow accounts are governed by states statutes that expressly give the manufacturers the option of opening, funding and maintaining an escrow account in lieu of becoming a signatory to the MSA. The statutes require companies, who are not signatories to the MSA, to deposit, on an annual basis, into qualified banks escrow funds based on the number of cigarettes or cigarette equivalents, i.e., the pounds of MYO tobacco, sold. The purpose of these statutes is expressly stated to be to eliminate the cost disadvantage the settling manufacturers have as a result of entering into the MSA. Non signatory companies are entitled to direct the investment of the escrowed funds and withdraw any appreciation, but cannot withdraw the principal for twenty-five years from the year of each annual deposit, except to withdraw funds deposited pursuant to an individual state s escrow statute to pay a final judgment to that state s plaintiffs in the event of such a final judgment against the Company. Either option becoming a MSA signatory or establishing an escrow account is permissible.

The Company has chosen to open and fund an MSA escrow account as its means of compliance. It is management s opinion, due to the possibility of future federal or state regulations, though none have to date been enacted, that entering into one or both of the settlement agreements or establishing and maintaining an escrow account would not necessarily prevent future regulations from having a material adverse effect on the results of operations, financial position and cash flows of the Company.

Various states have enacted or proposed complementary legislation intended to curb the activity of certain manufacturers and importers of cigarettes or make-your-own tobacco that are selling into MSA states without signing the MSA or who have failed to properly establish and fund a qualifying escrow account. To the best of our knowledge, no such statute has been enacted which could inadvertently and negatively impact the Company, which has been and is currently fully compliant with all applicable laws, regulations and statutes, but there can be no assurance that the enactment of any such complementary legislation in the future will not have a material adverse effect on the results of operations, financial position or cash flows of the Company.

Pursuant to the MSA escrow account statutes, in order to be compliant with the MSA escrow requirements, the Company is required to deposit such funds for each calendar year into a qualifying escrow account by April 15 of the following year. At December 31, 2006, the Company had on deposit approximately $18.7 million which is recorded in Other assets. The Company will be depositing approximately $3.0 million into this account by April 15, 2007, relating to 2006 sales. During 2006, approximately $4.0 million was deposited into this qualifying escrow account. The Company is entitled to direct the investment of the escrow funds and is allowed to withdraw any appreciation, but cannot withdraw the principal for twenty-five years from the year of each annual deposit, except to withdraw funds deposited pursuant to an individual state s escrow statute to pay a final judgment to that state s plaintiffs in the event of such a judgment against the Company. The investment vehicles available to the Company are specified in the state escrow agreements and are limited to low risk government securities.

17

Table of Contents

**Risks Related to Industry**

***The Company is subject to substantial and increasing regulation which could adversely affect demand for its tobacco products.***

A wide variety of federal, state and local laws limit the advertising, sale and use of tobacco products, in particular cigarettes, and these laws have proliferated in recent years. For example, television and radio advertisements of cigarette products have been prohibited since 1971, and many local laws prohibit smoking in restaurants and other public places. Private businesses have also adopted regulations which prohibit or restrict, or are intended to discourage, smoking. Companies subject to the MSA and other state settlement agreements generally cannot use billboard advertising, cartoon characters, sponsorship of concerts, non-tobacco merchandise bearing its brand names and various other advertising and marketing techniques to sell their cigarettes. In addition, the MSA prohibits the targeting of youth in advertising, promotion or marketing of cigarette products. Additional restrictions may be legislatively imposed or agreed to in the future. Recent proposals have included limiting tobacco advertising to black-and-white, text-only advertisements. These limitations may make it difficult to maintain the value of an existing brand if sales or market share decline for any reason. Moreover, these limitations significantly impair the ability of cigarette manufacturers, including the Company, to launch new premium brands in those states party to the MSA. For example, three states have enacted legislation that imposes additional fees or taxes on the products of companies which have not entered into state tobacco settlements.

In 1986, federal legislation was enacted regulating smokeless tobacco products (including dry and moist snuff and chewing tobacco) by, among other things, requiring health warning notices on smokeless tobacco packages and advertising and prohibiting the advertising of smokeless tobacco products on media subject to the jurisdiction of the Federal Communications Commission. Since 1986, other proposals have been made at both the federal, state and local levels for additional regulation of smokeless tobacco products and it is likely that additional proposals will be made in future years.

Recently proposed federal, state and local regulations on tobacco products have included increased regulation of the manufacturing and marketing of tobacco products by new or existing federal and state agencies, the requirement of additional warning notices, a ban or further restriction on all advertising and promotion, ingredients disclosure requirements, sampling and advertising bans or restrictions, increasing the minimum purchase age and the disallowance of advertising and promotion expenses as deductions under federal tax law. These proposals, if implemented, could adversely affect demand for the Company s products and have a material adverse effect on its results of operations, financial position and cash flows.

The U.S. Food and Drug Administration has also sought regulatory authority over tobacco products and has indicated that, if Congress enacts legislation granting such authority, it would likely promulgate regulations which may severely restrict the manufacture, distribution and sale of tobacco products and may require compliance with a wide range of labeling, reporting, record keeping, manufacturing and other requirements, among other things. These types of regulations, if implemented, could have a material adverse effect on the Company s results of operations, financial position and cash flows.

***Competition from other tobacco companies could adversely affect the Company.***

The tobacco industry is characterized by brand recognition and loyalty, with product quality, price, marketing and packaging constituting the primary methods of competition. Substantial marketing support, merchandising display, competitive pricing and other financial incentives generally are required to introduce a new brand or improve or maintain a brand s market position. Rival firms aggressively seek to limit the distribution of other companies products, both at the wholesale and retail levels. If rival firms were able to limit the Company s distribution it could adversely affect its plans to increase the distribution of certain of the Company s products and otherwise adversely affect its results of operations, financial position and cash flows.

The Company s primary competition for our MYO tobacco and related products comes from a number of other manufacturers of MYO tobacco and related products and, from a pricing standpoint, from U.S. manufacturers of discount cigarettes, as well as from importers of cigarettes manufactured in foreign countries. The Company s primary competition for its ***Zig-Zag*** Premium Cigarette brand comes from the major cigarette manufacturers. The Company s smokeless tobacco products compete with major smokeless tobacco manufacturers. Many of the Company s competitors have substantially greater financial, manufacturing, marketing and other resources than its does and in many cases have a more established presence in the market than it does. The Company cannot assure you that in the face of this competition the Company s existing products will maintain their market position or grow or that its new products, such as the Company s ***Zig-Zag*** Premium Cigarettes, will gain market acceptance. A decrease in sales of the Company s existing products or the incurrence of expenses to launch new products which are not ultimately accepted could have a material adverse effect on its results of operations, financial position and cash flows.

18

***Sales of tobacco products are generally expected to continue to decline, which could have a material adverse effect on the Company s revenues and cash flows.***

As a result of restrictions on advertising and promotions, funding by the major cigarette manufacturers of smoking prevention campaigns, increases in regulation and excise taxes, health concerns, a decline in the social acceptability of smoking, increased pressure from anti-tobacco groups, and other factors, the overall U.S. markets for cigarette and smokeless tobacco products have generally been declining in terms of volume of sales, and are expected to continue to decline. The Company has similarly experienced a decline in sales of its loose leaf chewing tobacco products. Further, while some sales volume declines have been offset by higher prices, there can be no assurance that price increases can be sustained. A decline in the Company s sales could have a material adverse effect on its results of operations, financial position and cash flows.

***Increased excise taxes on tobacco products could have a material adverse effect on the Company s results of operations, financial position and cash flows.***

Smokeless tobacco products are subject to federal excise tax, and the federal excise tax on them has increased three times over the last decade. Most recently, on January 1, 2002 the federal excise tax on loose leaf chewing tobacco was increased to $0.195 per pound from $0.17 per pound. Also on January 1, 2002, the federal excise tax on premium cigarette paper was increased to $0.0122 from $0.0106 per fifty papers, the federal excise tax on cigarette tubes was increased to $0.0244 from $0.0213 per fifty tubes and the federal excise tax on MYO tobacco was increased to $1.0969 from $0.9567 per pound. Future enactment of increases in federal excise taxes on the Company s smokeless tobacco products and on MYO products could have a material adverse effect on demand for them and on its results of operations, financial position and cash flows. Smokeless tobacco products are also subject to certain state and local excise taxes. The state excise taxes generally range from 2% to 129% of the wholesaler s or the manufacturer s list price of the smokeless tobacco product. Any enactment of new state or local excise taxes or an increase in existing excise taxes on the Company s smokeless tobacco products could have a material adverse effect on demand for them and on its results of operations, financial position and cash flows.

Cigarettes are also subject to substantial and increasing excise taxes. On January 1, 2002, the federal excise tax included in the price of cigarettes increased by $2.50 to $19.50 per thousand cigarettes (or $0.39 per pack of 20 cigarettes). Additional excise taxes, which are levied upon and paid by the distributors, are also in effect in the 50 states, the District of Columbia and many municipalities. Various states have proposed, and certain states have recently passed, increases in their state tobacco excise taxes. The state taxes generally range from $.025 to $2.05 per package of 20 cigarettes. Future enactment of increases in federal or state excise taxes on the Company s ***Zig-Zag*** Premium Cigarettes could adversely affect demand for them and have a material adverse effect on its results of operations, financial position and cash flows. The Company is unable to predict the likelihood of passage or magnitude of future increases in excise taxes.

***The Company may not be able to develop, produce or commercialize competitive new products and technologies required by regulatory changes or changes in consumer preferences.***

Consumer health concerns and changes in regulations are likely to require us to introduce new products or make substantial changes to existing products. For example, New York State enacted legislation in 2002 which went into in effect in June, 2004, requiring that cigarette manufacturers reduce the ignition propensity of their products. The Company cannot assure you that it will be able to meet the requisite standards without adversely affecting the Company s profitability and without adversely affecting the taste of its product, or otherwise reducing consumer acceptance. Similarly, the Company believes that there will be increasing pressure from public health authorities to develop a conventional cigarette or an alternative cigarette that provides a demonstrable reduced risk of adverse health effects. The Company may not be able to develop a reduced risk product that is acceptable to public health authorities and consumers in a cost-effective manner, or at all. Costs associated with developing new products and technologies, as well as the inability to develop acceptable products in response to competitive conditions or regulatory requirements, could have a material adverse effect on the Company s results of operations, financial position and cash flows.

**Risks Related to the Company s Business**

***Infringement of the Company s intellectual property may affect its results of operations, financial position and cash flows.***

The Company currently relies on trademark and other intellectual property rights to establish and protect its brand names and logos. Third parties have in the past, and may in the future, infringe on these trademarks and other intellectual property rights. In particular, in the past few years the Company has incurred substantial litigation costs prosecuting

19

distributors of infringing and counterfeit ***Zig-Zag*** premium cigarette papers in the United States. Despite the Company s attempts to ensure that its intellectual property rights are protected, third parties may take actions that could materially and adversely affect the Company s rights or the value of its intellectual property. Any litigation concerning the Company s intellectual property rights, whether successful or unsuccessful, could result in substantial costs to it and diversions of its resources. Expenses related to protecting the Company s intellectual property rights, the loss or compromise of any of these rights or the loss of revenues as a result of infringement could have a material adverse effect on its results of operations, financial position and cash flows.

***The outcome of material litigation, if determined adversely to the Company, could have a material adverse effect on its results of operations, financial position and cash flows.***

On July 8, 2003, following a four day trial, an Illinois jury returned a verdict in favor of Republic Tobacco, L.P. on defamation claims of $8.4 million in general damages and $10.2 million in punitive damages, for a total damage award of $18.6 million. The Company filed post-trial motions for a new trial and, in the alternative, for a reduction of the awards. On August 1, 2003, the Company posted a judgment bond in the amount of $18.8 million with the U.S. District Court. This was accomplished by obtaining a $19.0 million senior secured term loan pursuant to a July 31, 2003 amendment to the Company s existing credit facility. On November 20, 2003, the court ruled that the awards were excessive and reduced the awards by approximately 60%, with the award of compensatory damages being reduced to $3.36 million and the award of punitive damages being reduced to $4.08 million, for a total of $7.44 million. On December 18, 2003, Republic accepted these reduced awards. On January 8, 2004, the Company appealed from the final judgment, including the finding of liability in this case as well as the amount of the award. There can be no assurance, however, that the Company will prevail on appeal. On January 22, 2004, Republic filed a general notice of cross appeal and argued in its appellate briefs that the judgment should be affirmed and also asserted, in its cross-appeal, that the original judgment should be reinstated despite its acceptance of the District Court s order reducing the judgment amount.

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

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

On August 3, 2005, the District Court issued its ruling and awarded the Company approximately $1.1 million. This amount is not recorded in the consolidated financial statements. On August 11, 2005, Republic Tobacco filed a notice of appeal. Briefing was completed and oral argument was held before the Court of Appeals in November 2006 and decision is pending.

On February 21, 2006, Top Tobacco, LP, an affiliate of Republic Tobacco, filed a complaint against North Atlantic Operating Company, Inc., a subsidiary of the Company, in the Federal District Court for the Northern District of Illinois, alleging that the Company s use of the phrase Fresh-Top Canister on the side of its ZIG-ZAG CLASSIC AMERICAN BLEND cigarette tobacco infringes, damages and violates Top Tobacco s TOP trademark for tobacco. Top Tobacco requests injunctive relief and unquantified royalties and damages. The parties completed discovery and the Company moved for summary judgment, seeking dismissal of a of Top Tobacco s claims. On January 4, 2007, the Court dismissed all of Top Tobacco s claims. On January 26, 2007, the Company asked the Court to declare that the case was extraordinary under the federal trademark laws which would allow the Company to recover its attorneys fees. Republic has the right to appeal the Court s decision. In the event of an appeal, the Company intends to vigorously defend any appealed claims and believes that it has strong defenses. However, no assurances can be given that the Company will prevail, and if the Company were to lose, there could be a material adverse event.

On May 16, 2006, Republic Tobacco L.P. ( Republic ) filed a complaint against the Company, NAOC and NTC in Federal District Court for the Northern District of Illinois, alleging that the defendants made oral and written presentations to Republic s customers that defamed Republic s president by implying he was not truthful in prior court testimony and wrongfully disparaged Republic s JOB cigarette paper products. Republic alleges the defendants conduct constituted false advertising in violation of the Lanham Act (Count I), represented a deceptive trade practice in violation of the Illinois Uniform Deceptive Trade Practices Act (Count II), violated the Illinois Consumer Fraud Act (Count III), constituted common law defamation, trade libel and commercial disparagement (Count IV), and, finally constituted unfair competition under common law (Count V).

20

On June 30, 2006, the defendants answered the complaint, denying all of the alleged violations and asserting several affirmative defenses. The defendants also counterclaimed against Republic for false advertising in the marketing of cigarette paper products in violation of the Lanham Act (Counterclaim Count I), for tortious interference with the defendants customers (Counterclaim Count II) and for deceptive trade practices in Republic s marketing of cigarette paper products, in violation of Illinois law (Counterclaim Count III). Currently pending is a fully-briefed motion by the defendants to add certain parties related to Republic. Discovery in the case has been completed and summary judgment motions have been filed and fully briefed. A decision of the Court is pending. The Company intends to vigorously defend these claims and believes that it has strong defenses to the claims. The Company also intends to vigorously prosecute its counterclaims. However, no assurances can be given that the Company will prevail, and if the Company were to lose, there could be a material adverse effect.

The Company has been named as a defendant in a number of other legal proceedings, including claims brought by individual plaintiffs alleging tobacco-related injuries. It is not possible to predict with certainty the outcome of the litigation pending against us. The Company also may be subject to additional claims in the future. Specifically, the tobacco industry and, in particular, the manufactured cigarette market, is subject to pervasive litigation. If any of the Company s current or future litigation is determined adversely, it could have a material adverse effect on its results of operations, financial position and cash flows.

***The departure of key management personnel could adversely affect the Company s operations.***

The Company s success depends upon the continued contributions of its senior management, including Douglas P. Rosefsky, President and Chief Executive Officer, Lawrence S. Wexler, Chief Operating Officer, and Brian C. Harriss, Chief Financial Officer. Although the Company has entered into employment agreements with Mr. Wexler and Mr. Harriss, the loss of the services of any or all of them could have a material adverse effect upon its business.

***The Company s failure to manage growth could adversely affect its business.***

The Company s strategy includes continued expansion, where possible, of its current loose leaf chewing tobacco and MYO cigarette businesses as well as leveraging and building its existing distribution network to grow its presence in the MYO tobacco and related products market and penetrate the premium segment of the manufactured cigarette market. Failure to manage this growth could have a material adverse effect on its results of operations, financial position and cash flows.

***The Company is subject to risks inherent in new product development initiatives.***

The Company has made and plans to continue to make significant investments in new product development projects. The Company launched a new ***Zig-Zag*** Premium Cigarette in September 2003 which the Company is currently testing in certain test markets. The launch of the ***Zig-Zag*** Premium Cigarette subjects the Company to increased levels of risk, uncertainties and contingencies, including the challenges inherent in new product development. The Company s testing of the ***Zig-Zag*** Premium Cigarette is limited to only certain test markets. ***Zig-Zag*** Premium Cigarettes may not be ultimately accepted by adult smokers and may not prove to be a commercially successful product.

***The Company may be unsuccessful in maintaining the consumer brand loyalty of its products.***

Brands are a very significant element in a tobacco company s value. Brand loyalty for tobacco products has historically been high, with a consumer s brand loyalty enduring for a long time. The Company believes that is has a strong brand portfolio of smokeless tobacco products, premium cigarette papers and other MYO tobacco and related products. The Company s continued success depends in part on its ability to protect and improve its brands continuously and on its ability to preserve the consumer s loyalty to these brands. There can be no assurance that branding by the Company s competitors will not be successful in persuading consumers of its products to switch to competitors products, which could have a material adverse effect on its results of operations, financial position and cash flows.

***The Company may face delays in obtaining tobacco, other raw materials and finished products manufactured for the Company.***

The Company does not grow or purchase from growers any of the raw tobacco products used in manufacturing its loose leaf chewing tobacco. Instead, it purchases its tobacco from third party leaf dealers. In the event that the Company is unable to meet product demands, its customers may seek to fulfill their supply needs by purchasing competing brands, which in turn would reduce the Company s market share and could have a material adverse effect on its results of operations, financial position and cash flows.

Table of Contents

Historically, the Company s MYO cigarette operations consisted solely of the marketing and distribution of finished MYO premium cigarette papers, as well as finishing the processing of and packaging, marketing and distributing its rag or cut MYO tobaccos and other tobacco related products. In connection with the Stoker acquisition, the Company acquired the equipment used to manufacture and package the Stoker brands of MYO tobacco. The Company does not manufacture any of its premium cigarette paper products and have entered into an agreement with Bolloré for the long-term supply of finished premium cigarette paper and other related products. Pursuant to the distribution and license agreements with Bolloré, under normal conditions, the Company must purchase these products only from Bolloré. In turn, Bolloré is required by the distribution and license agreements to provide the Company with the quantities of these products that it desires. Bolloré has from time to time been unable to produce and supply the Company with sufficient quantities of cigarette tubes and injectors due, in part, to the rapid growth in its sales of those products. Although the Company has put in place certain safeguards including the maintenance by it of a supply of inventory, and by Bolloré of a two-month supply of immediately available safety stock inventory at a public warehouse in the United States, and the ability under certain circumstances to sell ***Zig-Zag*** premium cigarette papers which are purchased from sources other than Bolloré, there can be no guarantee that the Company s supplies of these products will be adequate for its projected needs.

There can be no guarantee that the Company will be able to meet product demands in a timely manner or that it will be able to find an alternate supplier if Bolloré is unable to or does not meet the Company s supply needs. In the event that the Company is unable to meet product demands, its customers may seek to fulfill their supply needs by purchasing competing brands, which in turn would reduce the Company s market share and could have a material adverse effect on its results of operations, financial position and cash flows.

***The Company s principal stockholder can exercise significant influence over it and his interests may conflict with that of its investors.***

The Company is privately held, and Thomas F. Helms Jr., Executive Chairman of the Board, has beneficial ownership of approximately 74.6% of the Company s outstanding shares of common stock (before giving effect to the exercise of certain outstanding warrants). Pursuant to a stockholders agreement to which Mr. Helms is a party, together with all of the Company s other management stockholders, Mr. Helms has the ability to elect all of the members of its Board of Directors. Accordingly, Mr. Helms interests may conflict with that of the Company s investors, as stockholders and bondholders may have divergent interests.

***The Company employee base includes manufacturing personnel covered by collective bargaining agreements.***

As of March 16, 2007, the Company employed a total of 299 full-time employees including 104 manufacturing employees represented by unions. The unionized employees are covered by three collective bargaining agreements. Two of these agreements, covering 102 employees will expire in January 2008. The other agreement, covering 2 employees, will expire in April 2008. A material discontinuation in the production of finished goods related to labor relations issues could reduce the Company s sales, market position and cash flow.

## Risks Related to the Notes

On February 17, 2004, NATC consummated the refinancing of its existing debt and preferred stock. The refinancing consisted principally of (1) the offering and sale of $200.0 million principal amount of senior notes (the Senior Notes ) by NATC, (2) NATC entering into of an amended and restated loan agreement that provided a $50.0 million senior secured revolving credit facility to NATC (which agreement was amended on January 19, 2005 to reduce the revolving credit facility to $35.0 million) and (3) the concurrent sale of $97.0 million aggregate principal amount at maturity of senior discount notes of the Company.

The Senior Notes are senior unsecured obligations of NATC, mature on March 1, 2012 and are guaranteed on a senior unsecured basis by all of the Company s existing and certain of its future subsidiaries. On June 16, 2005, NATC refinanced the $35.0 million amended and restated loan agreement by entering into a Financing Agreement, which consists of a $30.0 million term loan facility and a $55.0 million revolving credit facility and includes a letter of credit sublimit of $10.0 million (collectively, the Credit Facility ). The Credit Facility will mature on June 30, 2010, and does not provide for any amortization of the term loan prior to maturity. Indebtedness under the Financing Agreement is guaranteed by the Company and each of NATC s current and future direct and indirect subsidiaries, and is secured by a first perfected lien on all of the Company s and its direct and indirect subsidiaries current and future assets and properties. For a more detailed description of the refinancings, the Senior Notes and the Credit Facility, see Management s Discussion and Analysis of Financial Condition and Results of Operations Results of Operations Liquidity and Capital Requirements. See also the discussion of the proposed Exchange Transaction under Item 1. Business Evolution of the Company.

***The Company has no operations and no material assets. Its subsidiaries have no obligation to make payments on the Senior Discount Notes, may not have sufficient cash flow or assets to make payments on the Senior Discount Notes, and may not be able to distribute to us any cash flow or assets they do have.***

The Company, the only legal entity with any obligation to make payments on the Senior Discount Notes, is a holding company with no operations or material assets of its own other than the capital stock of NATC, which itself is a holding company with no operations or assets of its own other than the capital stock of various operating subsidiaries. Operations are conducted through NATC and its subsidiaries and the Company s ability to make payments on the Senior Discount Notes is dependent on the earnings and the distribution of funds from its subsidiaries through loans, dividends or otherwise. However, none of its subsidiaries are obligated to make funds available to the Company for payment on the Senior Discount Notes. The terms of NATC s Credit Facility and the indenture governing the Senior Notes significantly restrict NATC from paying dividends and otherwise transferring assets to the Company. There can be no assurance that the agreements governing the current and future indebtedness of the Company s subsidiaries will permit its subsidiaries to provide the Company with sufficient dividends, distributions or loans to fund cash interest payments on the Senior Discount Notes when scheduled to begin on September 1, 2008.

Given the restrictions in NATC s debt instruments, the Company currently anticipates that, in order to pay the principal amount at maturity of the Senior Discount Notes or to repurchase the Senior Discount Notes upon a change of control as defined in the indenture governing the Senior Discount Notes, the Company will be required to adopt one or more alternatives, such as refinancing some or all of its indebtedness, selling its equity securities or the equity securities or assets of NATC or seeking capital contributions. There can be no assurance that any of the foregoing actions would enable the Company to refinance its indebtedness or pay the principal amount of the Senior Discount Notes or that any of such actions would be permitted by the terms of the indenture governing the Senior Discount Notes or any other of the Company s debt instruments then in effect.

***The Company s substantial debt could adversely affect its results of operations, financial position and cash flows and prevent NATC from fulfilling its obligations under the Senior Notes and Senior Discount Notes.***

The Company has a substantial amount of debt outstanding. As of December 31, 2006, NATC had approximately $233.6 million of debt outstanding and the Company had an additional accreted value of $37.4 million of debt outstanding.

The Company s leverage could have important consequences to the holders of the Senior Notes and Senior Discount Notes. For example, it could:

- make it more difficult for NATC to satisfy its obligations with respect to the Senior Notes and Senior Discount Notes or other debt;
- increase its vulnerability to competitive pressures and to general adverse economic or market conditions;
- require the Company to dedicate a substantial portion of its cash flow from operations to servicing debt, reducing the availability of its cash flow to fund working capital, capital expenditures, acquisitions and other general corporate purposes;
- limit its flexibility in planning for, or reacting to, changes in its business and industry; and
- limit its ability to obtain additional sources of financing.

All holders of debt incurred at the Company s subsidiaries would have a claim on the assets or cash flows of such subsidiary that is prior to any claim that the holders of the Senior Discount Notes would have.

***The Company may incur additional debt in the future, which could increase the noteholders credit risk.***

As of December 31, 2006, NATC had approximately $51.4 million available for borrowing under its revolving credit facility. Although NATC s Credit Facility and the indentures governing the Senior Notes and Senior Discount Notes restrict the Company and its restricted subsidiaries

from incurring additional debt, these restrictions are subject to important exceptions and qualifications. If the Company or its subsidiaries incur additional debt, the risks that the Company and its subsidiaries now face as a result of its leverage could intensify.

***The Company s operations will be substantially restricted by the terms of its debt, which could adversely affect its operating and financing flexibility.***

NATC s Credit Facility and the indenture governing the Senior Notes and Senior Discount Notes include a number of significant restrictive covenants. These covenants restrict, among other things, its ability to:

incur additional debt;

- pay dividends on its capital stock or repurchase its capital stock;
- make certain investments;
- enter into certain types of transactions with affiliates;
- limit dividends or other payments by its restricted subsidiaries to the Company;
- incur liens; and
- sell certain assets or merge with or into other companies.

These restrictions could limit the Company s ability to plan for or react to market conditions or to meet capital requirements.

NATC s Credit Facility contains financial covenants that require us to maintain compliance with specified financial ratios, which are described below in Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations under the Liquidity and Capital Requirements section. NATC s ability to comply with these covenants and requirements may be affected by events beyond its control, and NATC may have to curtail some of its operations and growth plans to maintain compliance.

The Company s and NATC s failure to comply with the covenants contained in its Credit Facility, the indenture governing the Senior Notes and Senior Discount Notes or other debt instruments, including as a result of events beyond the Company s control, could result in an event of default that could cause debt to be accelerated.

If the Company is not able to comply with the covenants and other requirements contained in its Credit Facility, the indentures governing the Senior Notes and Senior Discount Notes or other debt instruments, an event of default under the relevant debt instrument could occur. If an event of default does occur, it could trigger a default under the Company s other debt instruments. The Company could be prohibited from accessing additional borrowings and the holders of the defaulted debt could declare amounts outstanding with respect to that debt to be immediately due and payable. The Company cannot be certain that its assets or cash flow would be sufficient to fully repay borrowings under its outstanding debt instruments or that the Company would be able to refinance or restructure the payments on those debt instruments. Even if the Company were able to secure additional financing, it may not be available on favorable terms. If an event of default were to occur under any material debt, all of the Company s other debt could be accelerated. If such debt is accelerated, holders of the notes are likely to recover funds only to the extent, if any, funds remain after all debt and other obligations of the Company s subsidiaries are repaid.

***The Senior Notes are unsecured and thus subordinated to NATC s secured debt.***

NATC s obligations under the Senior Notes, and the obligations of the subsidiary guarantors under their respective guarantees, are unsecured. As a result, the Senior Notes are subordinated to all of NATC and the subsidiary guarantors secured debt to the extent of the collateral securing that debt. As of December 31, 2006, NATC had approximately $33.6 million of secured debt outstanding, which represents NATC s and its subsidiaries obligations under its term loan, $30.0 million, and revolver, $3.6 million, facilities. NATC s obligations under the Credit Facility are secured by substantially all of NATC s and its subsidiaries assets. In the event that NATC is not able to pay amounts due under the Credit Facility, the lenders could proceed against the collateral securing that debt. In that event, any proceeds received upon a realization of the collateral would be applied first to amounts due under NATC s Credit Facility before any proceeds would be available to make payments on the Senior Notes. If there is a default, the value of this collateral may not be sufficient to repay both the lenders under its Credit Facility and the holders of the Senior Notes.

***The Company may not be able to satisfy its obligations to the noteholders upon a change of control.***

In the event of a change of control, the Company will be required to offer to purchase all of the outstanding Senior Discount Notes at a price equal to 101% of the principal amount thereof, plus accrued and unpaid interest thereon to the date of purchase. In the event of a change of control, there would also be a change of control under the Senior Notes. In the event of a change of control under the Senior Notes, NATC will be required to offer to purchase all of the outstanding Senior Notes at a price equal to 101% of the principal amount thereof, plus accrued and

unpaid interest thereon to the date of purchase, and holders of the Senior Notes will have a prior claim on all of the Company s subsidiaries assets, including the assets of NATC. It is possible that the Company and NATC will not have sufficient funds at the time of the change of control to make the required repurchase of the Senior Discount Notes and Senior Notes or that restrictions in its Credit Facility may not allow such repurchases. The Company s and NATC s failure to purchase the Senior Discount Notes and Senior Notes would be a default under the indenture governing the Senior Discount Notes and Senior Notes.

**Item 1B. Unresolved Staff Comments**

None.

**Item 2. Properties**

As of December 31, 2006, the Company operated manufacturing, distribution, office and warehouse space in the United States with a total floor area of approximately 704,413 square feet. Of this footage, approximately 600,000 square feet are owned and 104,413 square feet are leased.

To provide a cost-efficient supply of products to its customers, the Company maintains centralized management of manufacturing and nationwide distribution facilities. The Company s three manufacturing and distribution facilities are located in Louisville, Kentucky, Frankfort, Kentucky, and Dresden, Tennessee.

The following table describes the principal properties of the Company as of December 31, 2006:

| Location | Principal Use | Square Feet | Owned or Leased |
|---|---|---|---|
| New York, NY | Former administrative office-currently subleased | 11,513 | Leased |
| Darien, CT | Administrative Office | 1,900 | Leased |
| Louisville, KY | Manufacturing, R&D, warehousing, distribution and administration | 600,000 | Owned |
| Dresden, TN | Catalog distribution facility | 76,000 | Leased |
| Frankfort, KY | Cigarette manufacturing | 15,000 | Leased |

Table of Contents

**Item 3. Legal Proceedings**

***Litigation with Republic Tobacco***

On July 15, 1998, NAOC and NTC, which are subsidiaries of the Company, filed a complaint (the Kentucky Complaint ) against Republic Tobacco, Inc. and its affiliates ( Republic Tobacco ) in Federal District Court for the Western District of Kentucky. Republic Tobacco imports and sells Roll-Your-Own ( RYO ) premium cigarette papers under the brand names JOB and TOP as well as other brand names. The Kentucky Complaint alleges, inter alia, that Republic Tobacco s use of exclusivity agreements, rebates, incentive programs, buy-backs and other activities related to the sale of premium cigarette papers in the southeastern United States violate federal and state antitrust and unfair competition laws and that Republic Tobacco defaced and directed others to deface NAOC s point of purchase vendor displays for premium cigarette papers by covering up the ***ZIG-ZAG*** brand name and advertising material with advertisements for Republic Tobacco s RYO cigarette paper brands. The Kentucky Complaint alleges that these activities constitute unfair competition under federal and state laws.

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

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

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

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

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

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

26

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

On August 3, 2005, the District Court issued its ruling and awarded NATC approximately $1.1 million. This amount is not recorded in the consolidated financial statements. On August 11, 2005, Republic Tobacco filed a notice of appeal. Briefing was completed and oral argument was held before the Court of Appeals in November 2006. On February 22, 2007, the Court issued an opinion, reversing in part, affirming in part and remanding for further proceedings. The Court ruled that the Company was entitled to interest costs incurred by the Company during the time between the filing of the notice of appeal and the decision reducing the judgment in the approximate amount of $170,000; that the Company was not entitled to interest costs during the post-trial period in the district court prior to the notice of appeal in the approximate amount of $327,000; and that the district court should allocate the proportion of the fixed fee incurred in financing the appeal bond between those two time periods. The total fixed fee was $595,000. Proceedings on remand have not yet commenced.

On February 21, 2006, Top Tobacco, LP, an affiliate of Republic Tobacco, filed a complaint against NAOC, a subsidiary of the Company, in the Federal District Court for the Northern District of Illinois, alleging that the Company s use of the phrase Fresh-Top Canister on the side of its ZIG-ZAG CLASSIC AMERICAN BLEND cigarette tobacco infringes, damages and violates Top Tobacco s TOP trademark for tobacco. Top Tobacco requests injunctive relief and unquantified royalties and damages. The parties completed discovery and the Company moved for summary judgment, seeking dismissal of Top Tobacco s claims. On January 4, 2007, the Court dismissed all of Top Tobacco claims. On January 26, 2007, the Company asked the Court to declare that the case was extraordinary under the federal trademark laws which would allow the Company to recover its attorneys fees. On January 26, 2007, Top Tobacco filed a notice of appeal. Briefing is currently scheduled to be completed by the end of May 2007. In the event of an appeal, the Company intends to vigorously defend any appealed claims and believes that it has strong defenses. However, no assurances can be given that the Company will prevail, and if the Company were to lose, there could be a material adverse event.

On May 16, 2006, Republic Tobacco L.P. ( Republic ) filed a complaint against the Company, NAOC and NTC in Federal District Court for the Northern District of Illinois, alleging that the defendants made oral and written presentations to Republic s customers that defamed Republic s president by implying he was not truthful in prior court testimony and wrongfully disparaged Republic s JOB cigarette paper products. Republic alleges the defendants conduct constituted false advertising in violation of the Lanham Act (Count I), represented a deceptive trade practice in violation of the Illinois Uniform Deceptive Trade Practices Act (Count II), violated the Illinois Consumer Fraud Act (Count III), constituted common law defamation, trade libel and commercial disparagement (Count IV), and, finally constituted unfair competition under common law (Count V).

On June 30, 2006, the defendants answered the complaint, denying all of the alleged violations and asserting several affirmative defenses. The defendants also counterclaimed against Republic for false advertising in the marketing of cigarette paper products in violation of the Lanham Act (Counterclaim Count I), for tortious interference with the defendants customers (Counterclaim Count II) and for deceptive trade practices in Republic s marketing of cigarette paper products, in violation of Illinois law (Counterclaim Count III). Currently pending is a fully-briefed motion by the defendants to add certain parties related to Republic. Discovery in the case has been completed and summary judgment motions have been filed and fully briefed. A decision of the Court is pending. The Company intends to vigorously defend these claims and believes that it has strong defenses to the claims. The Company also intends to vigorously prosecute its counterclaims. However, no assurances can be given that the Company will prevail, and if the Company were to lose, there could be a material adverse effect.

***Litigation Related to Counterfeiting***

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

On May 18, 2001, NATC, in conjunction with Bolloré and law enforcement authorities conducted raids on the businesses and homes of certain defendants previously enjoined (including Tarek Makki and Adham Makki) from selling

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

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

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

On April 13, 2004, the Court entered an order (the Contempt 2 Order ), finding Ali Mackie, Tarek Makki, Adham Mackie and their companies Best Price Wholesale (the Makki Defendants ) and Harmony Brands LLC in civil contempt, freezing all of their assets, releasing the July 12, 2002 Final Judgment of $11.0 million from the forbearance agreement as to the Makki Defendants, and again referring the matter to the United States Attorney for Criminal Prosecution. Subsequent to the entry of the Contempt 2 Order, the Company settled with defendant Harmony Brands and its members for the amount of $750,000 and the entry of a permanent injunction. The Company is seeking to execute on the outstanding $11.0 million judgment against the remaining Makki Defendants and those efforts are currently underway.

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

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

On July 1, 2004, the Court issued an Order awarding approximately $2.5 million in damages to NATC for the damages incurred by the Company as a result of the Import Warehouse Defendants civil contempt. On July 15, 2004, the Court entered a Final Judgment in that amount for which defendants Import Warehouse, Inc. and Ravi Bhatia are jointly and severally liable. After NATC and Bolloré commenced collection proceedings, Import Warehouse paid NATC and Bolloré an amount equal to the entire judgment plus the expenses incurred in collection. Accordingly, approximately $1.2 million has been recorded in Selling, general and administrative expenses during the third quarter of 2004. The Import Warehouse Defendants filed a notice of appeal on July 24, 2004. The appeal has been fully briefed. Oral argument has been scheduled for April 30, 2007.

On September 23, 2005, in Bolloré S.A. v. Beydoun, CV05-1679 S, NATC and Bolloré filed a complaint in the United States District Court for the Western District of Louisiana against certain individuals and companies alleging that they had engaged in a conspiracy to manufacture and distribute counterfeit Zig-Zag cigarette papers in the United States. The complaint sought, among other things, an injunction and damages. The civil case follows the conviction on federal criminal counterfeiting charges of one of the alleged participants in the conspiracy. Discovery has concluded. NATC has resolved the matter with all defendants but one, and the trial date for that one remaining defendant is currently scheduled for June 2007.

Table of Contents

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

West Virginia Complaints. Trial of the West Virginia complaints against the smokeless tobacco defendants has been postponed indefinitely, as described below. On October 6, 1998, NTC was served with a summons and complaint on behalf of 65 individual plaintiffs in an action in the Circuit Court of Kanawha County, West Virginia, entitled Kelly Allen, et al. v. Philip Morris Incorporated, et al. (Civil Action Nos. 98-C-240l). On November 13, 1998, NTC was served with a second summons and complaint on behalf of 18 plaintiffs in an action in the Circuit Court of Kanawha County, West Virginia, entitled Billie J. Akers, et al. v. Philip Morris Incorporated et al. (Civil Action Nos. 98-C-2696 to 98-C-2713). The complaints are identical in most material respects. In the Allen case, the plaintiffs have specified the defendant companies for each of the 65 cases. NTC is named in only one action. One Akers plaintiff alleged use of an NTC product, alleging lung cancer.

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

On September 19, 2000, NTC was served with a second summons and complaint on behalf of 561 separate plaintiffs filed in Circuit Court of Ohio County, West Virginia, entitled Ronald Accord, et al. v. Philip Morris Inc., et al. (Civil Action Nos. 00-C-923 to 00-C-1483). A total of five of these plaintiffs alleged use of a product currently manufactured by NTC. One of these plaintiffs does not specify the time period during which the product was allegedly used. Another alleges use that covers, in part, a period when NTC did not manufacture the product. On motion by cigarette company defendants, this claim was dismissed on February 11, 2004, for failure to follow the case management order. On a subsequent motion by the plaintiffs counsel to reconsider dismissal, all previously dismissed plaintiffs were given a chance to potentially revive their claims by providing additional information to the trial court by September 18, 2006. This plaintiff did not do so and the dismissal of his claim was reaffirmed by order dated October 16, 2006. Of the remaining three, one alleges consumption of a competitor s chewing tobacco from 1966 to 2000 and NTC s *Beech-Nut* chewing tobacco from 1998 to 2000; another alleges a twenty-four year smoking history ending in 1995 and consumption of *Beech-Nut* chewing tobacco from 1990 to 1995; and the last alleges a thirty-five year smoking history ending in 2000, and consumption of NTC s *Durango Ice* chewing tobacco from 1990 to 2000 (although *Durango Ice* did not come onto the market until 1999).

In November 2001, NTC was served with an additional four separate summons and complaints in actions filed in the Circuit Court of Ohio County, West Virginia. The actions are entitled Donald Nice v. Philip Morris Incorporated, et al. (Civil Action No. 01-C-479), Korene S. Lantz v. Philip Morris Incorporated, et al. (Civil Action No. 01-C-480), Ralph A. Prochaska, et al. v. Philip Morris, Inc., et al. (Civil Action No. 01-C-481), and Franklin Scott, et al. v. Philip Morris, Inc., et al., (Civil Action No. 01-C-482). On August 19, 2004, the Korene Lantz lawsuit was voluntarily dismissed by the plaintiff against all defendants including NTC. The Donald Nice lawsuit was dismissed on July 18, 2005 against all defendants including NTC for failure of the plaintiff to follow the case management order. On a subsequent motion by the plaintiffs counsel to reconsider dismissal, all previously dismissed plaintiffs were given a chance to potentially revive their claims by providing additional information to the Court by September 18, 2006. The additional information was submitted in a timely fashion on behalf of Plaintiff Nice and therefore, the July 15, 2005 dismissal of his claims has been conditionally vacated. At some point in the future, the trial court will decide whether sufficient evidence exists to allow the claim to proceed.

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

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

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

By opinion dated December 2, 2005, the Supreme Court of Appeals of West Virginia completed its review of a certified question arising from the trial court s initial trial plan that had been established to resolve claims against the

cigarette manufacturer defendants. The Supreme Court of West Virginia determined that the United States Supreme Court s decision in State Farm Mutual Automobile Insurance Company v. Campbell, 538 U.S. 408 (2003), did not preclude a trial plan in which Phase I of the plan would decide certain elements of liability and a punitive damages multiplier and Phase II would decide each plaintiff s entitlement to compensatory damages and punitive damages based upon the multiplier determined in Phase I. The action was remanded to the circuit court to fashion a new trial plan for the consolidated cases. The trial court has now re-instituted the original trial plan with regard to the claims against the cigarette manufacturer defendants and has set the trial of Phase I to begin in March 2008. The trial court has not yet formulated a new trial plan with regard to the claims against the cigarette manufacturer defendants. The claims against the smokeless tobacco manufacturer defendants remain severed and indefinitely stayed. While the Company intends to defend these cases vigorously should they ever go to trial, and believes it has strong defenses, no assurances can be given the Company would prevail. If the Company were not to prevail, the result could be a material adverse event.

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

***Other Employment Matters***

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

David I. Brunson, the former President, Chief Financial Officer and Treasurer of the Company, resigned from the Company effective January 19, 2005, at which time his employment agreement with the Company (the Brunson Employment Agreement ) was effectively terminated. Pursuant to the Brunson Employment Agreement, the Company is required to make certain severance payments to Mr. Brunson, including $425,000 which was paid within ten business days after January 19, 2005, and an additional $425,000 which was paid in bi-weekly installments from January 20, 2005 through January 19, 2006. In addition, Mr. Brunson may become entitled to a bonus payment of up to $725,000 relating to synergies achieved in the integration of the business of Stoker, Inc., which was acquired by the Company in 2003. Mr. Brunson s last severance payment has been made and, pursuant to the Brunson Employment Agreement, Mr. Brunson has an option to require the Company to repurchase all or a portion of his shares of the Company at their fair market value. The Company will not be obligated to repurchase these shares if, upon or after the payment, it would be in default under any instrument, agreement or law by which it is bound; in this case, the repurchase may be deferred until it can be completed without such default. Similarly, the Company has an option to repurchase Mr. Brunson s shares at their fair market value. In the event the Company and Mr. Brunson are unable to agree upon the fair market value of these shares, an independent investment banking firm will be selected to determine such fair market value, in accordance with the procedure provided for by the Brunson Employment Agreement. If neither Mr. Brunson nor the Company exercise their respective options by the earliest of the fifth anniversary of the termination of Mr. Brunson s employment or the date on which the Company refinances, or uses proceeds derived from refinancing, certain of its obligations, the Company will be required to repurchase Mr. Brunson s shares on such date unless Mr. Brunson waives his right to require the Company to purchase his shares. During the first quarter 2005 and twelve months ended December 31, 2005, the Company recorded approximately $1.1 million relating to the resignation of Mr. Brunson. Any options or shares of restricted stock granted to Mr. Brunson vested in full as of the date of such resignation.

On January 23, 2006, Mr. Brunson filed a verified complaint against the Company in the Supreme Court of New York, County of Westchester, alleging breach of his employment agreement and related claims arising out of his resignation from employment with the Company. Mr. Brunson claims that he is entitled to $1.5 million in unpaid severance pay and at least $1.2 million in unpaid incentive bonus compensation under his employment agreement. Alternatively, Mr. Brunson seeks payment of the alleged unpaid incentive bonus compensation under differing, but related theories of recovery. Mr. Brunson also seeks payment of his attorneys fees. The Company disputed Mr. Brunson s allegations and responded to Mr. Brunson s complaint on March 31, 2006 by filing a motion to dismiss four of seven claims contained in Mr. Brunson s complaint on the grounds that they were duplicative or otherwise improper. In a decision dated July 6, 2006, the Court granted the Company s motion and dismissed four of seven claims contained in Mr. Brunson s complaint. The Company answered Mr. Brunson s remaining claims on July 27, 2006. Mr. Brunson and the Company reached an agreement in principle for a settlement, subject to final documentation and agreement, of any and all asserted or potential claims against the Company, pursuant to which the Company would pay Mr. Brunson $1.5 million and forgive his outstanding promissory note of $60,000 plus accrued interest. These amounts were recorded as an expense during the three months ended September 30, 2006. A settlement agreement was executed between the Company and Mr. Brunson on December 18, 2006 in the amount outlined above and paid on December 28, 2006.

On November 27, 2005, in Owens v. National Tobacco Company (Cal Super. Ct. Case No. BC343611), two former employees filed claims alleging racial and gender discrimination against the Company following the Company s dismissal of those employees for poor performance. The parties reached a settlement, the terms of which were immaterial to the Company s operations.

30

Table of Contents

A&M is entitled to a fee based on improvement in the Company s financial performance as measured against the Company s 2005 Business Plan, to be paid upon the termination of the engagement. One portion of the fee will be a specified percentage of the sustainable annualized EBITDAR improvement, as defined, and the other portion of the fee will be an amount to be determined by the Board of Directors of the Company in their reasonable judgment for significant and sustainable improvement in working capital investment and management, in each case as measured against the Company s 2005 Business Plan. As of December 31, 2006, no related liability or expense has been recorded relating to financial performance improvements.

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

None.

**PART II**

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

There is no established public trading market for the Company s Voting Common Stock, par value $.01 per share, 100% of which is owned by the Company.

No dividends have been declared or paid on the Voting Common Stock. Except as described below, the policy of the Company s Board of Directors is to retain any future earnings to provide funds for the operation and expansion of the Company s business. The Board of Directors reserves the right, however, to review the dividend policy periodically to determine whether the declaration of dividends is appropriate.

In connection with the refinancing of NATC s existing debt and preferred stock on February 17, 2004 (as described under Part I, Item 1, Business Evolution of the Company above and in Part I, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations below), the Company offered and sold $97.0 million aggregate principal amount at maturity (March 1, 2014) of senior discount notes. Interest on these notes will become payable semiannually in cash, at the rate of 12-1/4% per annum, commencing March 1, 2008. As the Company is a holding company with no operations or material assets other than the capital stock of NATC, its ability to make payments on such notes is dependent on the distribution of funds (through loans, dividends or otherwise) from NATC. It is currently contemplated that NATC will declare and pay dividends to fund the Company s interest payment obligations under its notes.

The payment of dividends by NATC is subject to restrictions contained in (i) the Company s Financing Agreement and (ii) the indenture governing NATC s senior notes.

**Item 6. Selected Financial Data**

| | Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2006 | 2005 | 2004 | 2003 | 2002 |
| | (amounts in thousands, except per share amounts) | | | | |
| **Statement of Operations Data:** | | | | | |
| Net sales[1] | $ 117,627 | $ 116,915 | $ 115,320 | $ 101,593 | $ 94,425 |
| Net income (loss)[1], [2], [3] | (12,032) | 10,117 | (34,922) | (6,241) | 5,485 |
| Net income (loss) applicable to common shares[1] | (12,032) | 10,117 | (36,535) | (13,516) | 3,904 |
| Basic earnings per common share: | | | | | |
| Net income (loss) applicable to common shares | $ (18.75) | $ 17.18 | $ (63.23) | $ (25.59) | $ 7.39 |
| Diluted earnings per common share: | | | | | |
| Net income (loss) applicable to common shares | $ (18.75) | $ 17.18 | $ (63.23) | $ (25.59) | $ 5.87 |

Table of Contents

| | | | | | |
|---|---|---|---|---|---|
| **Common stock cash dividends per share** | $ | $ | $ 8.20 | $ | $ |
| **Balance Sheet Data (at end of period):** | | | | | |
| Total assets | $ 220,816 | $ 225,784 | $ 232,398 | $ 243,644 | $ 213,594 |
| Total debt, including current maturities | $ 270,987 | $ 263,195 | $ 281,122 | $ 191,986 | $ 160,500 |
| Mandatorily redeemable preferred stock | | | | 65,080 | 57,805 |

(1) Net income (loss) and net income applicable to common shares for the year ended December 31, 2003, includes expenses of $7.4 million relating to the Republic judgment and $3.3 million relating to the terminated Star asset purchase agreement.

(2) Net income (loss) and net income applicable to common shares for the year ended December 31, 2004, includes income of $4.5 million relating to the Republic judgment.

(3) Includes federal excise taxes of $2,999, $3,158, $3,251, $1,899, and $1,684 for the years ended December 31, 2006, 2005, 2004, 2003 and 2002, respectively.

Table of Contents

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

**General**

The Company is the third largest manufacturer, marketer and distributor of loose leaf chewing tobacco in the United States and the largest marketer and distributor in the United States and Canada of premium cigarette papers. The Company is also a leading manufacturer, marketer and distributor of MYO smoking tobaccos and related products. In addition, in September 2003, the Company began marketing and distributing premium manufactured cigarettes in certain test markets under the ***ZIG-ZAG*** Premium Cigarettes brand name.

The Company generates revenues from the sale of its products primarily to wholesale distributors who in turn resell them to retail operations. The Company s net sales, which include federal exercise taxes, consist of gross sales, net of cash discounts, returns, and selling and marketing allowances.

The Company s principal operating expenses include the cost of raw materials used to manufacture its products; the cost of finished products, which are purchased goods; direct labor; federal excise taxes and tobacco quota buyout payments; manufacturing overhead; and selling, general and administrative expenses, which includes sales and marketing related expenses, legal expenses and compensation expenses, including benefits costs of salaried personnel. In 2002, the Company ceased the amortization of goodwill in accordance with FASB Statement 142, Goodwill and Other Intangible Assets ( Statement 142 ) and consequently, beginning in 2002, amortization of goodwill no longer constitutes one of the Company s principal operating expenses. The Company s other principal expenses include interest expense and amortization of deferred financing costs and other expenses, the last of which has arisen during the last several years and has during 2001 and 2002 primarily represented the legal, investigative and related costs associated with the Texas and California Infringing Products Litigations instituted by the Company against alleged counterfeiters of ***ZIG-ZAG*** premium cigarette papers and during 2003 and 2004 primarily represented the Republic litigation judgment and subsequent reduction, respectively.

The following factors have affected the Company s results during the period of 2002 to 2006:

The existence of counterfeit cigarette papers bearing the ***ZIG-ZAG*** trademark. From 1999-2002, management believes the Company lost in excess of $10 million of net sales and incurred approximately $7 million in expenses relating to the litigation and investigation of counterfeiting claims and to brand promotions intended to offset damage done to the legitimate distribution channels. While management believes that the inflow and sale of counterfeit products has been substantially reduced as a result of the actions taken by the Company during this period, it is believed that some level of counterfeit product continues to enter the market.

The impact of increased manufactured cigarette prices. Management believes such price increases have resulted in higher MYO cigarette sales. During the period of 2001 to 2006, a number of states increased their excise taxes on cigarettes. Management expects this trend to continue as more states seek additional sources of revenue to combat significant budget deficits.

The continuing downward trend of loose leaf chewing tobacco consumption. This is a result of an aging consumer base coupled with an increasing trend of consumers switching to moist snuff. Management believes that the switch to moist snuff has been caused, in part, by the increased distribution and interest in the discount moist snuff category combined with these moist snuff products being priced at the same levels or lower than loose leaf products. Historically, increased prices for loose leaf products have largely offset this downward trend in consumption. Management expects this pricing trend to continue and, as a result, the Company expects that this segment s contribution to the Company s earnings will remain relatively constant and stable for the foreseeable future.

The impact of currency fluctuations. Currency movements and suppliers price increases relating to premium cigarette papers, cigarette tubes and cigarette injector machines are the primary factors affecting cost of sales. Those products are purchased from Bolloré on terms of net 45 days and are payable in Euros. Thus, the Company bears certain foreign exchange risks for its inventory purchases. To minimize this risk, the Company has in the past and may in the future choose to utilize short-term forward currency contracts, through which the Company secures Euros in order to provide payment for its monthly purchases of inventory. In 2005, the Company approved, adopted and instituted a formal Foreign Exchange Currency Policy and more actively contracted for the forward purchase of Euros.

The impact of marketing and promotional initiatives. Historically, based upon the timing of the Company s marketing and promotional initiatives, the Company has experienced significant variability in its month-to-month results. Promotional activity significantly increases net sales in the month in which it is initiated, while net sales are adversely impacted in the month after a promotion.

Management Changes: On January 19, 2005, the Company engaged the firm of Alvarez & Marsal, LLC ( A&M ), a global professional services firm, specializing in providing interim senior management, restructuring and corporate advisory services, and appointed Mr. Douglas P. Rosefsky, a Managing Director of A&M, as Interim Chief Financial Officer upon the resignation of the Company s former Chief Financial Officer. On April 11, 2005, Mr. Rosefsky was appointed President and Chief Executive Officer and the Company retained Mr. Brian C. Harriss as Senior Vice President and Chief Financial Officer. At the time of these appointments, Mr. Thomas Helms, Jr., formerly Chairman and Chief Executive Officer, was appointed Executive Chairman. On June 8, 2005, Mr. Lawrence S. Wexler, former President of NACC, was appointed Chief Operating Officer of the Company.

Restructuring Program: Coincident with the retention of Mr. Rosefsky, the Company commenced a restructuring program to improve sales, reduce costs, streamline operations, focus on higher return activities and increase operating cash flow.

Refinancing: On June 16, 2005, NATC refinanced its existing $35.0 million Amended and Restated Loan Agreement, dated as of February 17, 2004, by entering into a Financing Agreement (the Financing Agreement ), as described in the Liquidity and Capital Requirements discussion below.

Sales and Marketing Realignment: In December 2005, the Company restructured and realigned its sales and marketing functions and established a unified organization structure. This action included the remapping of sales territories to better align the Company s sales force with the relative market development of its products, customers and consumers.

**Results of Operations**

For financial reporting purposes, the Company has three reporting segments: smokeless tobacco, which principally includes the sale of loose leaf chewing tobacco; MYO, which includes sales of premium cigarette papers and MYO tobacco and related products; and premium manufactured cigarettes. The Company launched its premium manufactured cigarette business late in the third quarter of 2003. To date, this business is in a developmental phase and its net sales results have not been significant while operating losses have been material. As a result of the Stoker acquisition, the Company also operates a catalog business which sells tobacco and non-tobacco products. The Stoker acquisition was completed on November 17, 2003.

**Summary**

The table and discussion set forth below relates to the consolidated results of operations and financial condition of the Company for the years ended December 31, 2006, 2005 and 2004.

| | Year Ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2006 | | 2005 | | 2004 | |
| | (amounts in thousands) | | | | | |
| Net sales | $ 117,627 | 100.0% | $ 116,915 | 100.0% | $ 115,320 | 100.0% |
| Cost of sales | 53,260 | 45.3 | 56,654 | 48.4 | 58,617 | 50.8 |
| Gross profit | 64,367 | 54.7 | 60,261 | 51.6 | 56,703 | 49.2 |
| Selling, general and administrative expenses | 47,806 | 40.6 | 46,025 | 39.4 | 32,670 | 28.3 |
| Amortization expense | 662 | 0.6 | 441 | 0.4 | 462 | 0.4 |
| Operating income | 15,899 | 13.5 | 13,795 | 11.8 | 23,571 | 20.5 |
| Interest expense, net, and deferred financing costs | 27,081 | 23.0 | 31,853 | 27.2 | 31,283 | 27.1 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Other income | | | 28,403 | 24.3 | | |
| Income (loss) before income taxes | (11,182) | (9.5) | 10,345 | 8.8 | (7,712) | (6.6) |
| Income tax expense | 850 | 0.7 | 228 | 0.2 | 27,210 | 23.6 |
| Net income (loss) | $ (12,032) | (10.2)% | $ 10,117 | 8.7% | $ (34,922) | (30.3)% |

**Comparison of Year Ended December 31, 2006 to Year Ended December 31, 2005**

*Net Sales*. For 2006, net sales were $117.6 million, an increase of $0.7 million or 0.6% from the prior year.

Net sales of the smokeless tobacco segment increased to $48.8 million from $44.0 million or 11.0% from the prior year. This increase is due principally to an aggregate average price increase of approximately 10.7% instituted during the second and fourth quarters of 2006 coupled with trade allowance reductions and an increase in aggregate gross case sales to 354,689 from 352,764, or 0.5%. The average aggregate list price per case was $173.68 and $158.20 as of December 31, 2006 and 2005, respectively.

Net sales of the MYO segment decreased to $63.3 million from $67.6 or 6.3% from the prior year. This decrease is due principally to a reduction in aggregate gross case sales from 428,205 to 355,912, or 16.9%, partially offset by an aggregate average price increase of 3.4% instituted during the first and second quarters of 2006 coupled with trade allowance reductions. The aggregate case volume decreased due to the Company s decision to withdraw its discount MYO tobaccos from the state of Michigan and greater competitive pricing activity in key MYO opportunity geographies. The average aggregate list price per case was $225.39 and $217.82 as of December 31, 2006 and 2005, respectively.

*Gross Profit.* For 2006, gross profit increased 6.8% to $64.4 million from $60.3 million for the prior year and gross margins increased to 54.7% from 51.6%.

Gross profit of the smokeless tobacco segment increased to $24.9 million in 2006 from $20.7 million for the prior year, or 22.2%. Gross margin for this segment increased to 51.1% of net sales for the current period from 46.4% in the prior year due primarily to the aggregate average price increase of approximately 10.7% and a reduction in manufacturing costs, partially offset by an increase in case sales of lower margin products.

Gross Profit of the MYO segment decreased 1.9% to $36.3 million from $37.0 million in 2006. The gross margin of the MYO segment increased to 57.4% for net sales for the current period from 54.8% in the prior year. This increase in gross margin was due principally to an aggregate average price increase of approximately 3.4% and a reduction in manufacturing costs, principally due to an aggregate average exchange rate lower than the prior year, partially offset by a reduction in total case sales volume with a higher case sales reduction in lower margin products.

*Currency*. Currency movements and suppliers price increases relating to premium cigarette papers, cigarette tubes and cigarette injector machines are the primary factors affecting cost of sales. Those products are purchased from Bolloré on terms of net 45 days and are payable in Euros. Thus, NAOC bears certain foreign exchange risks for its inventory purchases. To minimize this risk, NAOC may choose to utilize short-term forward currency contracts, through which NAOC secures Euros in order to provide payment for its monthly purchases of inventory. In July 2005, the Board of the Company approved the Company s Foreign Exchange Risk Management Policy and Procedures. During 2006, the Company executed various forward contracts for the purchase of 14.0 million Euros with maturity dates from March 6, 2006 to April 20, 2007. As of December 31, 2006, the Company recognized a gain of approximately 0.01 million. On December 31, 2006, contracts with a total Euro commitment of 0.4 million with maturity dates from March 23, 2007 to April 20, 2007 were outstanding.

*Selling, General and Administrative Expenses*. Selling, general and administrative expenses for 2006 increased 3.9% to $47.8 million from the prior year s $46.0 million. This increase was due primarily to the settlement with Mr. Brunson of approximately $1.5 million and a write down to net realizable value of approximately $1.1 million relating to the Helms note, offset primarily by a decrease in compensation expense.

*Amortization Expense*. Amortization of goodwill was eliminated effective January 1, 2002. Amortization expense totaling $0.7 million for the year ending December 31, 2006 related to the intangible assets acquired from Stoker.

*Interest Expense and Financing Costs.* Interest expense and financing costs decreased to $27.1 million in 2006 from $31.9 million for the prior year. This decrease was the due principally to lower average outstanding indebtedness.

*Other Expense (Income).* Other income of $28.4 million in 2005 is related to the gain on the repurchase of the Senior Discount Notes during 2005. There was no Other expense (income) in 2006.

*Income Tax Expense*. The Company has determined that at December 31, 2006, its ability to realize future benefits of net deferred tax assets does not meet the more likely than not criteria in SFAS No. 109, Accounting for Income Taxes . Therefore, a valuation allowance has been recorded. The Company has determined in calculating the valuation allowance that only deferred tax liabilities relating to property, plant and equipment should be netted against deferred tax assets in determing the amount of the valuation allowance. Deferred tax expense related to inventories and tax-deductible goodwill, as well as actual incurred tax expense is being recorded in 2006. In 2005, only deferred tax expense related to inventories and tax-deductible goodwill was recorded. Tax expense for the years ended December 31, 2006 and 2005 was $0.9 million and $0.2 million, respectively. As of December 31, 2006, a valuation allowance continues to be recorded.

*Net Income (Loss)*. Due to the factors described above, the Company incurred a net loss of $12.0 million for 2006 compared to net income of $10.1 million for 2005.

**Comparison of Year Ended December 31, 2005 to Year Ended December 31, 2004**

*Net Sales*. For 2005, net sales were $116.9 million, an increase of $1.6 million or 1.4% from the prior year.

Net sales of the smokeless tobacco segment decreased from $46.2 million to $44.0 million or 4.7% from the prior year. This is due principally to an aggregate average price increase of 5.3% instituted during the second quarter of 2005 coupled with trade allowance reductions partially offset by a decrease in aggregate gross case sales to 352,764 from 383,856 or 8.1%. As of December 31, 2005 and 2004, the average aggregate list price per case was $158.20 and $150.47, respectively.

Net sales of the MYO segment increased from $63.5 million to $67.6 million or 6.3% from the prior year. This increase was due to an aggregate average price increase of 7.1% instituted during the second quarter of 2005 coupled with trade allowance reductions and an increase in aggregate gross case sales to 428,205 from 399,087 or 6.8%. The aggregate case volume increase was due principally the continuing recovery from counterfeiting activity coupled with increases in prices and taxes of manufactured cigarettes. The average aggregate list price per case was $217.82 and $203.13 as of December 31, 2005 and 2004, respectively.

*Gross Profit.* For 2005, gross profit increased 6.3% to $60.3 million from $56.7 million for the prior year and gross margins increased to 51.6% from 49.2%.

Gross profit of the smokeless tobacco segment decreased to $20.4 million in 2005 from $20.8 million for the prior year, or 1.8%. Gross margin of this segment increased to 46.4% of net sales in 2005 from 45.0% of net sales for the prior year. This increase is attributed primarily to the aggregate average price increase of 5.3% instituted during the second quarter of 2005.

Gross Profit of the MYO segment increased 12.8% to $37.0 million from $32.8 million in 2004. The gross margin of the MYO segment increased to 54.8% of net sales for the current period from 50.9% in the prior year. This increase in gross margin was due principally to an aggregate average price increase of approximately 7.1%, a reduction in manufacturing costs, principally due to an aggregate average exchange rate lower than the prior year and an increase in aggregate gross case sales.

*Currency*. Currency movements and suppliers price increases relating to premium cigarette papers, cigarette tubes and cigarette injector machines are the primary factors affecting cost of sales. Those products are purchased from Bolloré on terms of net 45 days and are payable in Euros. Thus, NAOC bears certain foreign exchange risks for its inventory purchases. To minimize this risk, NAOC may choose to utilize short-term forward currency contracts, through which NAOC secures Euros in order to provide payment for its monthly purchases of inventory. In July 2005, the Board of the Company approved the Company s Foreign Exchange Risk Management Policy and Procedures. During 2005, the Company executed various forward contracts for the purchase of 6.7 million Euros with maturity dates from October 20, 2005 to July 28, 2006. As of December 31, 2005, the Company recognized a loss of approximately $0.06 million. On December 31, 2005, contracts with a total Euro commitment of $3.9 million with maturity dates from March 3, 2006 to July 28, 2006 were outstanding.

*Selling, General and Administrative Expenses*. Selling, general and administrative expenses for 2005 increased 40.7% to $46.0 million from the prior year s $32.7 million. This increase was due primarily to restructuring costs of approximately $5.9 million, $2.1 million related primarily to legal expenses incurred to combat counterfeiting, $0.5 million compensation expense and shipping costs of $0.5 million. In 2004, the Company received $4.5 million associated with the reduction in the judgment rendered against the Company in connection with the litigation with Republic Tobacco, Inc.

*Amortization Expense*. Amortization of goodwill was eliminated effective January 1, 2002. Amortization expense totaling $0.4 million for the year ending December 31, 2005 related to the intangible assets acquired from Stoker.

**Table of Contents**

*Interest Expense and Financing Costs.* Interest expense and deferred financing costs increased to $31.9 million in 2005 from $31.3 million for the prior year. This increase was the result of a full year of amortization expense relating to the Senior Discount Notes.

*Other Expense (Income).* Other income of $28.4 million in 2005 is related to the gain on the repurchase of the Senior Discount Notes during 2005. There was no Other expense (income) in 2004.

*Income Tax Expense*. Income tax expense was $0.2 million for 2005. Income tax expense was $27.2 million for 2004, reflecting the net loss of the Company and the recording of the valuation reserve relating to the realization of the net deferred taxes of $26.5 million. The valuation reserve as of December 31, 2005 is $29.6 million.

*Net Income (Loss)*. Due to the factors described above, the Company recorded net income of $10.1 million for 2005 compared to a net loss of $34.9 million for 2004.

**Liquidity and Capital Requirements**

The Company s principal uses for cash are working capital, debt service, its annual MSA escrow account deposit and capital expenditures. The Company s principal sources of cash are from operating cash flows and from borrowings under its revolving credit facility. As described below, NATC consummated the refinancing of its existing Amended and Restated Loan Agreement on June 16, 2005.

The Company believes that its operating cash flows, together with borrowings under the Financing Agreement, subject to its ability to be in compliance with the covenants thereunder or to obtain waivers or amendments of such covenants or its ability to refinance the Financing Agreement, should be adequate to satisfy its reasonably foreseeable operating capital requirements.

Working capital was $16.2 million at December 31, 2006 compared to $19.5 million at December 31, 2005. This decrease was the result of an increase in the revolving credit facility of $3.6 million and a decrease in inventory and other current assets of $2.9 million, partially offset by a decrease in accounts payable and accrued expenses of $2.2 million and a higher cash balance of $1.3 million.

During 2006, the Company had $1.7 million in capital expenditures. The Company believes that its capital expenditure requirements for 2007 will be between $2.0 million and $3.0 million.

For the year ended December 31, 2006, net cash used in operating activities was $0.7 million compared with net cash provided by operating activities of $2.0 million for the year ended December 31, 2005. This change was due primarily to the reduction in accounts payables partially offset by a reduction in accrued expenses.

For the year ended December 31, 2006, net cash used in investing activities was $1.7 million compared with $4.8 million for the year ended December 31, 2005. This change was due to investing in capital expenditures.

For the year ended December 31, 2006, net cash provided by financing activities was $3.7 million compared with $1.0 million for the year ended December 31, 2005. This change was due primarily to borrowings related to the revolving credit facilities in 2006.

On February 17, 2004, NATC consummated the refinancing of its existing debt and preferred stock. The refinancing consisted principally of (1) the offering and sale of $200.0 million principal amount of the Senior Notes (the Senior Notes ) by NATC, (2) NATC entering into of an amended and restated loan agreement that provides a $50.0 million senior secured revolving credit facility to NATC and (3) the concurrent sale of $97.0 million aggregate principal amount at maturity of senior discount notes of the Company.

The Senior Notes are senior unsecured obligations of NATC, mature on March 1, 2012 and are guaranteed on a senior unsecured basis by all of NATC s existing and certain of its future subsidiaries. The Senior Notes bear interest at the rate of 9¼% per annum from the date of issuance, or from the most recent date to which interest has been paid or provided for, and interest is payable semiannually on March 1 and September 1 of each year. NATC is not required to make mandatory redemptions or sinking fund payments prior to the maturity of the Notes. NATC or the Company may from time to time seek to retire all or a portion of the Senior Notes through cash purchases and/or exchanges for other securities in open market purchases, privately negotiated transactions or otherwise.

On and after March 1, 2008, the Senior Notes are redeemable, at NATC s option, in whole at any time or in part from time to time, upon not less than 30 nor more than 60 days prior notice at the following redemption prices (expressed in

percentages of principal amount), if redeemed during the 12-month period commencing March 1 of the years set forth below, plus accrued and unpaid interest to the redemption date (subject to the right of holders of record on the relevant record date to receive interest due on the relevant interest payment date):

| Year | Redemption Price |
| --- | --- |
| 2008 | 104.625% |
| 2009 | 102.313% |
| 2010 and thereafter | 100.000% |

In addition, prior to March 1, 2008, NATC may redeem the Senior Notes, at its option, in whole at any time or in part from time to time, upon not less than 30 nor more than 60 days prior notice at a redemption price equal to 100% of the principal amount of the Senior Notes redeemed plus a make-whole premium based on U.S. Treasury rates as of, and accrued and unpaid interest to, the applicable redemption date.

The Senior Notes limit the incurrence of additional indebtedness, the payment of dividends, entering into transactions with affiliates, asset sales, engaging in mergers or acquisitions, creating liens or other encumbrances on assets, and other matters.

See the discussion of the proposed Exchange Transaction under Item 1. Business Evolution of the Company.

On June 16, 2005, NATC refinanced the 2004 Credit Agreement by entering into the Financing Agreement with various financial institutions ( Lenders ) and Fortress Credit Corp., as agent for the Lenders ( Agent ). The Financing Agreement consists of a $30.0 million term loan facility and a $55.0 million revolving credit facility, and includes a letter of credit sublimit of $10.0 million (collectively, the Credit Facility ). As of December 31, 2006, NATC had an outstanding balance of $3.6 million on the revolving credit facility. The Credit Facility will mature on June 30, 2010, and does not provide for any amortization of the term loan prior to maturity. NATC and its subsidiaries will use the revolving credit facility for working capital requirements and other general corporate purposes. Indebtedness under the Financing Agreement is guaranteed by the Company and each of NATC s current and future subsidiaries, and is secured by a first perfected lien on substantially all of the Company s and its direct and indirect subsidiaries current and future assets and property. The collateral includes a pledge by the Company of its equity interest in NATC and a first priority lien on all equity interests and intercompany notes held by the Company and its direct and indirect subsidiaries.

Loans and advances under the Financing Agreement bear interest at a variable rate based on either the prime rate or LIBOR, at the Company s option, plus a specified margin ranging from 1.00% to 3.75% in case of prime rate indebtedness, and from 3.50% to 6.25% in the case of LIBOR indebtedness, based on the sum of the Company s secured indebtedness in relation to its EBITDAR, as defined in the Financing Agreement. As of December 31, 2006, the interest rate on the Company s term loan and revolving credit facility was 8.875% and 9.25%, respectively.

NATC paid the Lenders a closing fee of $1.275 million and is required to pay the Agent a quarterly servicing fee in the amount of $25,000. Under the revolving credit facility, NATC is required to pay the Lenders an annual commitment fee in an amount equal to 0.50% of the difference between $40.0 million and the average usage of the revolving credit facility, payable on a monthly basis. NATC is also required to pay the Lenders letter of credit fees equal to 4.00% per annum multiplied by the face amount of the letters of credit issued under the Financing Agreement, payable on the date any such letter of credit is issued. In addition, NATC is required to pay the Agent the standard charges customarily charged by the institution issuing letters of credit under the Financing Agreement in connection with the issuance, administration, amendment, payment or cancellation of any such letters of credit.

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

The Financing Agreement contains customary events of default, including payment defaults, breach of representations and warranties, covenant defaults, cross-acceleration, cross-defaults to certain other indebtedness, bankruptcy and insolvency, the occurrence of a Change of Control, as defined in the Financing Agreement, and judgment defaults. Further, it is an event of default under the Financing Agreement if an event or development occurs that results in a Material Adverse Effect (as defined in the Financing Agreement), as determined by the Agent in its reasonable business judgment. If any events of

default occur and are not cured within applicable grace periods or waived, the outstanding loans may be accelerated and the Lenders commitments may be terminated. The occurrence of the bankruptcy and insolvency event of default will result in the automatic termination of commitments and acceleration of outstanding loans under the Financing Agreement.

Concurrently with the offering of the Senior Notes, the Company issued $97.0 million aggregate principal amount at maturity ($60.0 million in gross proceeds) of its senior unsecured discount notes due 2014 (the Senior Discount Notes ). Proceeds of approximately $53.8 million from this issuance were used to make a capital contribution to NATC. The Senior Discount Notes are the Company s senior obligations and are unsecured, ranking equally in right of payment to all of the Company s future unsubordinated obligations and senior in right of payment to any obligations that are by their terms subordinated to the Senior Discount Notes, and will be effectively subordinated to any secured obligations of the Company to the extent of the assets securing those obligations. The Senior Discount Notes are not guaranteed by NATC or any of its subsidiaries and are structurally subordinated to all of NATC and its subsidiaries obligations, including the Senior Notes. The Company or NATC may from time to time seek to retire all or a portion of the Senior Discount Notes through cash purchases and/or exchanges for other securities in open market purchases, privately negotiated transactions, or otherwise. For a description of the Company s repurchase of Senior Discount Notes, see Note 5 to the consolidated financial statements contained herein.

On and after March 1, 2009, the Senior Discount Notes will be redeemable, at the Company s option, in whole at any time or in part from time to time, upon not less than 30 nor more than 60 days prior notice at the following redemption prices (expressed in percentages of principal amount at maturity), if redeemed during the 12-month period commencing March 1 of the years set forth below, plus accrued and unpaid interest to the redemption date (subject to the right of holders of record on the relevant record date to receive interest due on the relevant interest payment date):

| **Year** | **Redemption Price** |
| --- | ---: |
| 2009 | 106.125% |
| 2010 | 104.083% |
| 2011 | 102.042% |
| 2012 and thereafter | 100.000% |

In addition, prior to March 1, 2009, the Company may redeem the Senior Discount Notes, at its option, in whole at any time or in part from time to time, upon not less than 30 nor more than 60 days prior notice at a redemption price equal to 100% of the accreted value of the Senior Discount Notes redeemed plus a make-whole premium based on U.S. Treasury rates as of, and accrued and unpaid interest to, the applicable redemption date.

The Senior Discount Notes limit the incurrence of additional indebtedness, the payment of dividends, entering into transactions with affiliates, asset sales, engaging in mergers or acquisitions, creating liens and other encumbrances on assets, and other matters.

The Company is dependent on NATC s cash flows to service its debt. The amount of cash interest to be paid during the next five years is as follows: $0 in each of 2007 and March 1, 2008; approximately $2,628 payable on September 1, 2008 and approximately $2,628 payable on each of March 1 and September 1, 2009, 2010, 2011 and thereafter until maturity.

On October 1, 2006, the Company and NATC (collectively, the Companies ) retained Lazard Frères & Co. LLC ( Lazard ) as the Companies financial advisor to assist the Companies in exploring and evaluating potential alternatives relating to a financial recapitalization of the Companies. In consultation with Lazard, the Companies considered various recapitalization alternatives, including an exchange (the Exchange Transaction ) of the Company s outstanding 12.25% Senior Discount Notes due 2014 (the Senior Discount Notes ), which were issued pursuant to that certain Indenture, dated as of February 17, 2004, between the Company and Wells Fargo Bank Minnesota, National Association, a national banking association ( Wells Fargo ), as Indenture Trustee, and a majority of NATC s outstanding 9.25% Senior Notes due 2012 (the Senior Notes ), which were issued pursuant to that certain Indenture, dated as of February 17, 2004, among NATC, the guarantors listed on the signature pages thereto and Wells Fargo, as Indenture Trustee, for new second lien secured notes of NATC (the Second Lien Notes ).

The Companies, with the assistance of Lazard, have held discussions with various holders of Senior Discount Notes and Senior Notes regarding the Exchange Transaction. As of the date of this filing, holders of 76.9% of the aggregate amount outstanding of the Senior Discount Notes and 54.84% of the aggregate amount outstanding of the Senior Notes have entered into written agreements in principle to participate in the Exchange Transaction on substantially the terms set forth in the Indicative Summary of Terms and Conditions (the Term Sheet ), which was filed as Exhibit 99.1 to the Registrant s Current Report on Form 8-K filed on March 21, 2007. The exchange ratio would be $950 principal amount and $812.50 principal

Table of Contents

amount of Second Lien Notes for each $1,000 principal amount of Senior Notes and Senior Discount Notes, respectively. The Exchange Transaction would be offered to the holders of at least a majority and up to 100% of the outstanding Senior Discount Notes and to certain holders of at least a majority and up to 55% of the outstanding Senior Notes. As part of the Exchange Transaction, the existing Indentures for the Senior Discount Notes and Senior Notes would be amended to eliminate many of the covenants and events of default contained therein. The Companies obligations to file reports with the Securities and Exchange Commission would terminate if the Exchange Transaction is consummated, although it would continue to make its financial statements and certain other information available to the indenture trustee for the Second Lien Notes and on a password protected website. The foregoing discussion of the Exchange Transaction and the Term Sheet is qualified in its entirety by reference to the full text of the Term Sheet, which was filed on March 21, 2007 as Exhibit 99.1 to the Registrant s Current Report on Form 8-K and is incorporated herein by reference. There can be no assurance, however, that this process will result in a definitive transaction, or as to the final terms thereof, or any other recapitalization transaction by the Companies. Any offering or issuance of the Second Lien Notes will not be and have not been registered under the Securities Act of 1933, as amended, and may not be offered or sold in the United States absent registration under, or an applicable exemption from the registration requirements of, such Act.

Pursuant to the U.S. Distribution Agreement (one of the Distribution Agreements, as more fully discussed in Item 1. Business), the Company is committed to purchase a minimum number of booklets of premium cigarette papers annually to avoid the termination of that agreement. This level of purchases has been significantly exceeded since the 1997 Acquisition and management believes that the Company will be able to significantly exceed this requirement for the foreseeable future. The agreement has also established the purchase price for ***ZIG-ZAG*** premium cigarette papers through 2004, subject to certain adjustments to reflect increases in the U.S. consumer price index and to account for material currency fluctuations. The Distribution Agreements provide that, in order to assure each of the parties commercially reasonable profits in light of inflationary trends and currency translation factors, prior to December 31, 2004 and each fifth-year anniversary of such date, the parties will enter into good faith negotiations to agree on an index and currency adjustment formula to replace the index and formula currently in effect. If the parties are unable to agree, the dispute is to be submitted to binding arbitration.

As discussed in Item. 1 Business State Attorney General Settlement Agreements, in order to be in compliance with the MSA and subsequent states statutes, the Company is required to fund an escrow account with each of the settling states based on the number of cigarettes or cigarette equivalents (i.e., the pounds of MYO smoking tobacco) sold in such state. Funding of the escrow deposit by the Company in 2006 was $3.4 million in respect of sales of MYO smoking products in 2005 and $0.6 million in respect of sales of MYO smoking products in 2006. The Company estimates the total deposits will be $3.0 million in 2007 relating to 2006 sales.

The following table summarizes the Company s contractual obligations at December 31, 2006 after giving effect to the refinancing of the Company s existing debt and preferred stock (in thousands):

| Contractual Obligations | Total | Less than 1 year | 1-3 years | 4-5 years | After 5 years |
|---|---|---|---|---|---|
| Senior discount notes | $ 42,900 | $ | $ | $ 42,900 | $ |
| Senior notes | 200,000 | | | 200,000 | |
| Interest on senior notes | 101,750 | 18,500 | 55,500 | 27,750 | |
| Financing Agreement | 33,600 | 3,600 | 30,000 | | |
| Interest on Financing Agreement | 9,283 | 2,723 | 6,560 | | |
| Purchase obligations | 13,054 | 13,054 | | | |
| Operating leases | 4,123 | 1,220 | 1,724 | 688 | 491 |
| | $ 404,710 | $ 39,097 | $ 93,784 | $ 271,338 | $ 491 |

**Inflation**

The Company believes that any effect of inflation at current levels will be minimal. Historically, the Company has been able to increase prices at a rate equal to or greater than that of inflation and believes that it will continue to be able to do so for the foreseeable future. In addition, the Company has been able to maintain a relatively stable variable cost structure for its products due, in part, to its successful procurement and reformulation activities with regard to its tobacco products and, in part, to its existing contractual agreement for the purchase of its premium cigarette papers.

**Critical Accounting Policies**

The Company believes the accounting policies below represent its critical accounting policies due to the estimation process involved in each. See Note 4, to the consolidated financial statements for a detailed discussion of the Company s accounting policies.

Table of Contents

*Goodwill and Other Intangible Assets* The Company has adopted Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets ( SFAS No. 142 ).

Under SFAS No. 142, goodwill is no longer to be amortized but reviewed for impairment annually or more frequently if certain indicators arise, using a two-step approach that first compares the book value to the fair value, no impairment exists if the fair value exceeds book value. If an impairment exists then step 2 measures the amount of the impairment. The goodwill balances attributable to each of the Company s reporting units are tested for impairment by comparing the fair value of each reporting unit to its carrying value as of December 31 each year. Fair value was determined by the Company through a projection of volumes, pricing, costs and inflation by segment and subsidiary, a projection of working capital and capital spending, and residual value at the end of the projection period to capitalize the future value of cash flows beyond the years projected; the overall resulting projected cash flows are discounted at a risk adjusted discount rate. The projections and valuations are analyzed against the yearend asset carrying value and a determination is made about the carrying value of goodwill and other intangible assets. The valuation process is most sensitive to the residual value and discount rate assumptions. If the residual value decreased by 5% and the discount rate increased by 5%, the computed value of goodwill and other intangible assets would still exceed the carrying value and no impairment would be necessary. The potential impairment of goodwill and other intangible assets does not lend itself to a retrospective review based on subsequent events or transactions as no real market transactions have occurred which could be used for such a review. The Company has not sold or disposed of any intangible asset. Variables such as projected volumes, pricing, costs, etc, are compared to future achieved results annually and such knowledge is used to assist in the determination of such factors for future computations. The Company has reported that no such impairment of goodwill and other intangible assets has occurred as of December 31, 2006.

*Taxes* The Company has provided a valuation allowance to reduce its net deferred income tax assets since it is management s judgment that it is not more likely than not to be able to realize these benefits before they expire. Accordingly, an adjustment to the net deferred income tax assets has been charged to earnings for the year ending December 31, 2006.

*Contingencies* Note 21 of the consolidated financial statements contained herein discusses various litigation matters that impact the Company. No loss or gain contingencies have been recorded for these matters because Management believes that it is not probable that a loss has been incurred or an asset realized as outlined in Statement of Accounting Standards No. 5, *Accounting for Contingencies*, as applied on a case by case basis. Future events may result in different conclusions, which could have a material impact, either positively or negatively, on the results or financial condition of the Company.

**Forward-looking Statements**

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

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

**Item 7A. Quantitative and Qualitative Disclosures about Market Risk**

*Interest Rate Sensitivity*. The Company has exposure to interest rate volatility primarily relating to interest rate changes applicable to revolving loans under its Financing Agreement. The Company s credit facility bears interest at rates which vary with changes in LIBOR or the prime rate. As of December 31, 2006, $33.6 million of the Company s debt bore interest at variable rates. The Company believes that the effect, if any, of reasonably possible near-term changes in interest rates on the

Company s consolidated financial position, results of operations or cash flows would not be significant. A 1% change in the interest rate would change pre-tax income by approximately $0.3+ million per year.

*Foreign Currency Sensitivity*. NAOC purchases inventory from Bolloré on terms of net 45 days which are payable in Euros. Accordingly, exposure exists to potentially adverse movement in foreign currency rates (Euros). In addition, Bolloré provides a contractual hedge against catastrophic currency fluctuation in its agreement with NAOC. NAOC does not use derivative financial instruments for speculative trading purposes, nor does NAOC hedge its foreign currency exposure in a manner that offsets the effects of changes in foreign exchange rates.

NAOC regularly reviews its foreign currency risk and its hedging programs and may as part of that review determine at any time to change its hedging policy. During 2005, the Company approved, adopted and instituted a formal Foreign Exchange Currency Policy and more actively contracted for the forward purchase of Euros. On December 31, 2006, the Company had outstanding purchase commitments of Euro 4.3 million. A 10% gain or loss in the value of the U.S. dollar versus the Euro would result in a gain or loss of $0.6 million. On December 31, 2006, the Company had firm foreign currency contracts to purchase a total amount of Euros 0.4 million. A 10% gain or loss in the value of the U.S. dollar would result in a loss or gain of $0.1 million.

**Item 8. Financial Statements and Supplementary Data**

The Company s Consolidated Financial Statements and Notes to Consolidated Financial Statements, and the reports of McGladrey & Pullen, LLP and PricewaterhouseCoopers LLP, independent registered public accounting firms, with respect thereto, referred to in the Index to Financial Statements of the Company contained in Item 15(a), appear on pages F-1 through F-30 of this Form 10-K and are incorporated herein by reference thereto. Information required by schedules called for under Regulation S-X is either not applicable or is included in the Consolidated Financial Statements or Notes thereto.

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

On May 16, 2006, the Audit Committee of the Board of Directors of the Company dismissed PricewaterhouseCoopers LLP ( PwC ) as the Company s independent registered public accounting firm and engaged McGladrey & Pullen, LLP ( McGladrey ) as the Company s new independent registered public accounting firm, effective immediately. During the Company s fiscal years ended December 31, 2004 and December 31, 2005 and through May 16, 2006, McGladrey was not consulted by the Company regarding (1) the application of accounting principles to a specified transaction, either completed or proposed, or the type of audit opinion that might be rendered on the Company s financial statements; or (2) any matter that